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GOVERNMENTAL LEASE FINANCING REFORM ACT

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

FIRST SESSION

ON

S. 1564

JULY 19, 1983

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CONTENTS

ADMINISTRATION WITNESSES

Page

Chapoton, Hon. John J., Assistant Secretary for Tax Policy, Department of the Treasury 46
Pyatt, Hon. Everett, Principal Deputy Assistant Secretary, Shipbuilding and Logistics, Department of the Navy 66
Mosemann, Hon. Lloyd K., Deputy Assistant Secretary, Logistics and Communications, Department of the Air Force 82

PUBLIC WITNESSES

Ainslie, Michael L., president, National Trust for Historic Preservation 148
Alexander, Donald C., member, Taxation Committee, U.S. Chamber of Commerce accompanied by David Franasiak 120
Banner, Delmar K., president, Farm Credit Council 203
Bell, Peter, executive director, National Housing Rehabilitation Association 144
Bennington College, Michael Hooker, president 106
Boeing Co., Donald McLaren, vice president, international affairs 165
Booth, John, National Resource Recovery Association, U.S. Conference of Mayors 184
Bratton, Daniel L., president, Kansas Wesleyan College, on behalf of the National Association of Independent Colleges and Universities 94
Computer and Business Equipment Manufacturers Association, Paul W. Oosterhuis, Esq 109
CTI—Container Transport International, Inc., John H. Parker, vice president and general counsel 170
Farm Credit Council, Delmar K. Banner, president 203
Financial Investment Associates, Fred Raffanello, president 178
Hanke, Steven H., senior fellow, Heritage Foundation 195
Heritage Foundation, Steven H. Hanke, senior fellow 195
Hooker, Michael, president, Bennington College 106
Joseph, Jerome E., vice president, District 2, Marine Engineers Beneficial Association-Associated Maritime Officers, AFL–CIO 160
Kehoe, John, senior vice president, business development, Signal-Resco on behalf of the National Solid Wastes Management Association 190
Lissenden, Jack, director of finance, city of Richmond, Va., on behalf of the Municipal Finance Officers Association 129
Marine Engineers Beneficial Association-Associated Maritime Officers, AFL–CIO, Jerome E. Joseph, vice president, District 2 160
McLaren, Donald, vice president, international affairs, Boeing Co 165
Metzenbaum, Hon. Howard M., a U.S. Senator from Ohio 40
Municipal Finance Officers Association, Jack Lissenden, director of finance, city of Richmond, Va. 129
National Association of Independent Colleges and Universities, Daniel L. Bratton, president, Kansas Wesleyan College 94
National Housing Rehabilitation Association, Peter Bell, executive director 114
National Resource Recovery Association, U.S. Conference of Mayors, John Booth 184
National Solid Waste Management Association, John Kehoe, senior vice president, business development, Signal-Resco 190
National Trust for Historic Preservation, Michael L. Ainslie, president 148
Oosterhuis, Paul W., Esq., Computer and Business Equipment Manufacturers Association 109

Page

Parker, John H., vice president and general counsel, CTI—Container Transport International, Inc. 170
Raffanello, Fred, president, Financial Investment Associates 178
St. Paul, Minn., James Scheibel, councilman 138
Scheibel, James, councilman, city of St. Paul, Minn 138
U.S. Chamber of Commerce, Donald C. Alexander, accompanied by David Franasiak 120

ADDITIONAL INFORMATION

Committee press release 24
Opening statement of Senator Dole 24
Opening statement of Senator Grassley 24
Text of bill S. 1564 26
Description of S. 1564 by the Joint Committee on Taxation 2
Prepared statement of Senator Metzenbaum 42
Prepared statement of Hon. John E. Chapoton 50
Prepared statement of Hon. Everett Pyatt 68
Prepared statement of Hon. Lloyd K. Mosemann 82
Prepared statement of Daniel L. Bratton 155
Prepared statement of Michael Hooker 107
Prepared statement of Paul W. Oosterhuis 110
Prepared statement of Donald C. Alexander 121
Prepared statement of Jack Lissenden 131
Prepared statement of James Scheibel 139
Prepared statement of Peter Bell 145
Prepared statement of Michael L. Ainslie 149
Prepared statement of Jerome E. Joseph 161
Prepared statement of Donald McLaren 166
Prepared statement of John H. Parker 171
Prepared statement of Fred Raffanello 179
Prepared statement of John Booth 185
Prepared statement of John Kehoe 191
Prepared statement of Steven H. Hanke 196
Prepared statement of Delmar K. Banner 204

COMMUNICATIONS

Prepared statement of Senator Alfonse D'Amato of New York 215
Letter from Senator Paul Sarbanes of Maryland 219
Prepared statement of Jacques T. Schlenger 220
Prepared statement of Gov. Bill Sheffield of Alaska 232
American Association of Museums 249
American Federation of State, County, and Municipal Employees 235
American Health Care Association 244
American Hospital Association 246
Associated General Contractors of America 253
Agus, Robert T. and William A. Davis, Jr 257
Association of American Medical Colleges 270
Barrett, Smith, Schapiro, Simon & Armstrong 272
City of Philadelphia 281
Damson Oil Corporation 359
Flexi-Van Corp 290
Governmental Refuse Collection & Disposal Association 299
Ingram Corp 303
Kidder, Peabody & Co. Inc 351
Lease Investment Corp 310
National League of Cities 319
National Hydropower Association 326
National Leased Housing Association 330
National Realty Committee 333
Sperry Corp 339
Thacher, Proffitt & Wood 341
Transamerica Interway 343
U.S. Conference of Mayors 346
Waste to Energy Project 348

GOVERNMENTAL LEASE FINANCING REFORM ACT

TUESDAY, JULY 19, 1983

U.S. Senate,
Committee on Finance,
Washington, D.C.

The committee met, pursuant to notice, at 9:32 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Robert Dole (chairman) presiding.

Present: Senators Dole, Chafee, Grassley, Long, Bentsen, and Boren.

Also present: Senator Metzenbaum.

[The press release announcing the hearing, the opening statement of Senators Dole and Grassley, the text of bill S. 1564, and a description of S. 1564 by the Joint Committee on Taxation follow:]

DESCRIPTION OF S. 1564 (GOVERNMENTAL LEASE FINANCING REFORM ACT OF 1983)

RELATING TO

TAX TREATMENT OF PROPERTY LEASED TO TAX-EXEMPT ENTITIES

SCHEDULED FOR A HEARING
BEFORE THE
COMMITTEE ON FINANCE
ON JULY 19, 1983

PREPARED BY THE STAFF
OF THE
JOINT COMMITTEE ON TAXATION

INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on July 19, 1983, on S. 1564 (Governmental Lease Financing Reform Act of 1983), introduced by Senators Dole, Metzenbaum, Durenberger, and Grassley. The bill relates to the tax treatment of property used by tax-exempt entities. This pamphlet, prepared in connection with the hearing, provides a description of the bill, present law, and related issues.

The first part of the pamphlet is a summary. The second part is a description of present law. The third part is a discussion of tax policy issues. Part four is a description of the provisions of the bill, including a comparison with the provisions of H.R. 3110 (on which a hearing was held by the House Committee on Ways and Means on June 9, 1983).

I. SUMMARY

Present Law

The Federal income tax benefits of ownership of property include accelerated cost recovery (ACRS) deductions and investment tax credits. Essentially, the law is that the economic substance of a transaction, not its form, determines who is entitled to the tax benefits associated with ownership. Thus, in a lease or similar arrangement, the person claiming ownership for Federal income tax purposes must show that he has sufficient economic indicia of ownership.

The tax benefits of ownership are generally allowed only for property used for a business or income-producing purpose. They are not available for property that is owned by governmental units and tax-exempt organizations. Property that is used (though not owned) by a tax-exempt organization or a domestic governmental unit qualifies for ACRS deductions, but generally does not qualify for investment credits. For example, property used under a lease by one of these entities is ineligible for investment credits. A statutory exception to this investment credit limitation is that qualified rehabilitation expenditures for a building leased to a tax-exempt organization or a governmental unit can qualify for the rehabilitation tax credit. Also, one court has held, and the Internal Revenue Service has ruled, that investment credits can be claimed where a governmental unit essentially contracts not for the use of property itself, but rather for a service to be provided by the owner of the property.

The investment credit is allowed for property used by any possession of the United States, any foreign government, or any foreign person. However, if property is used predominantly outside the United States, then, in general, ACRS deductions are reduced and no investment credit is allowed.

Present law rules relating to the ownership of property (in the context of leases or similar arrangements), the investment credit limitation, and the tax treatment of property used predominantly outside the United States are described in part II.

Issues

The recent increase in leasing and similar transactions by tax-exempt entities raises a number of tax policy issues. These issues include: (a) the extent to which the benefits of ACRS deductions and investment credits should be made available to tax-exempt entities that engage in leasing; (b) the efficiency of leasing as a means of providing assistance to tax-exempt lessees; (c) the Federal revenue loss; (d) the impact of governmental leasing on public budgeting processes; (e) the possibly adverse effect on public perceptions about the fairness of the income tax system; and (f) whether leasing facilitates the private supply of public services ("privatization"). These issues are addressed in part III.

Description of the Bill

In general, S. 1564 would reduce the tax benefits available for property that is leased to or otherwise used by tax-exempt entities (with exceptions for certain short-lived property, certain real property and property subject to short-term leases).

In general, the bill would require that ACRS deductions for property used by tax-exempt entities be computed using the straight-line method over a recovery period equal to the greater of the present class life of the property under the Asset Depreciation Range (ADR) system (40 years in the case of 15-year real property) or, in the case of property subject to a lease, 125 percent of the term of the lease. In the case of 15-year real property, this provision would apply to the extent of the use by a tax-exempt entity, but only if more than 50 percent of the property is used under circumstances specified in the bill. ACRS deductions for mass commuting vehicles that are eligible for safe-harbor leasing under present law would not be affected by the bill.

The bill would also provide criteria for determining whether a transaction that is structured as a service contract should be treated as a lease for purposes of the depreciation and investment tax credit provisions. The rehabilitation credit would be denied for real property that is subject to the slower depreciation rules provided by the bill.

The bill would generally apply to property placed in service by the taxpayer after May 23, 1983. However, it would not apply to property used pursuant to written binding contracts that meet certain requirements.

The bill is described in detail in part IV.

II. PRESENT LAW

A. Overview

Under present law, the rules for determining who is entitled to the tax benefits associated with the ownership of property generally are not written in the Internal Revenue Code; rather, they are embodied in a series of court cases and revenue rulings and revenue procedures issued by the Internal Revenue Service (IRS). Essentially, these rules focus on the economic substance of a transaction, not its form, for determining who (if anyone) is entitled to the tax benefits of ownership of property. Thus, in a lease or similar arrangement, the person claiming ownership for Federal income tax purposes must show that he has sufficient economic indicia of ownership.

In general, the tax benefits of ownership of property include depreciation or accelerated cost recovery (ACRS) deductions and investment tax credits. Generally, ACRS deductions and investment credits are allowed only for property used for a business or income-producing purpose.

As a general rule, governmental units and tax-exempt organizations are not entitled to ACRS deductions or investment tax credits for property owned by them. Moreover, no investment tax credit is allowed for property used (even though not owned) by a tax-exempt organization in its exempt function or by a governmental unit (nontaxable use restriction). This nontaxable use restriction does not affect the allowance of ACRS deductions and certain other tax benefits.

Property used by a foreign government or person is not subject to the nontaxable use restriction. However, if the property is used predominantly outside the United States (foreign-use property), then, in general, ACRS deductions are reduced and no investment credit is allowed.

The traditional reasons for leasing stem from tax, accounting, and a variety of business considerations.[1] Tax-exempt organizations and governmental units have leased equipment for many of the same reasons as taxable entities. The recent increase in leasing and similar arrangements is due, in part, to budgetary limitations on the purchase of property and, in the case of some State and local governments, limitations on the ability to issue tax-exempt bonds. From a tax perspective, leasing allows certain tax benefits (such as ACRS deductions) to flow through (in the form of reduced rents) to nontaxable entities that are not eligible for such benefits on their own account. The reasons for arranging a transaction with a nontaxable entity as a service contract in some cases stem from the desire to avoid the nontaxable use restriction on the investment credit.[2]

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[1] These considerations are discussed in the pamphlet, "Analysis of Safe-Harbor Leasing" (JCS-23-82), published in 1982 by the staff of the Joint Committee on Taxation.

What follows is a description of the present law rules governing the determination of ownership of property for Federal income tax purposes, in the context of leases or similar arrangements, and a description of the nontaxable use restriction on the investment tax credit. In the final section, the rules governing ACRS and the investment credit for foreign-use property are discussed.

B. The Ownership Issue

Overview

The determination of ownership of property requires a case-by-case analysis of all facts and circumstances. Although the determination of ownership is inherently factual, a number of general principles have been developed in court cases, revenue rulings, and revenue procedures.[3]

In general, both the courts and the IRS focus on the substance of the transaction rather than its form. The courts do not disregard the form of a transaction simply because tax considerations are a significant motive, so long as the transaction also has a bona fide business purpose and the person claiming tax ownership retains sufficient burdens and benefits of ownership.

In general, for Federal income tax purposes, the owner of property must retain meaningful burdens and benefits of ownership.[4] The lessor must be the person who suffers (or benefits) from fluctuations in value. Thus, lease treatment is denied, and the lessee is treated as the owner, if the user has the option to obtain title to the property at the end of the lease for a price that is nominal in relation to the value of the property at the time when the option is exercisable (as determined at the time the parties entered into the agreement), or which is relatively small when compared with the total payments required to be made.[5]

Where the lessor's residual value in the property is nominal, the lessor is viewed as having transferred full ownership of the property for the rental. Where the purchase option is more than nominal but relatively small in comparison with fair market value, the lessor is viewed as having transferred full ownership because of the likelihood that the lessee will exercise the bargain purchase option.[6] Furthermore, if the lessor has a contractual right to require the lessee to purchase the property at the end of the lease (a "put"), the transaction could be denied lease treatment because the put eliminates the lessor's risk of fluctuation in value of the residual interest and the risk that there will be no market for the property at the end of the lease.

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[2] See the pamphlet "Tax Aspects of Federal Leasing Arrangements" (JCS-3-83), published on February 25, 1983, by the staff of the Joint Committee on Taxation, for a discussion of the policy issues raised by leasing and similar arrangements involving nontaxable entities.

[3] These general principles are described fully in the Joint Committee staff pamphlet "Analysis of Safe Harbor Leasing" (JCS-23-82), and to a lesser extent in the pamphlet "Tax Aspects of Federal Leasing Arrangements" (JCS-3-83).

[4] See, *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978), *rev'g.*, 536 F.2d 746 (8th Cir. 1976).

[5] See, Rev. Rul. 55-540, 1955-2 C.B. 39 (and cases cited therein).

[6] See, *M&W Gear Co. v. Commissioner*, 446 F.2d 841 (7th Cir. 1971).

Objective guidelines used in structuring transactions

To give taxpayers guidance in structuring leveraged leases (i.e., where the property is financed by a nonrecourse loan from a third party) of equipment, the IRS issued Revenue Procedure 75-21, 1975-1 C.B. 715, and a companion document, Revenue Procedure 75-28, 1975-1 C.B. 752 (the guidelines). If the requirements of the guidelines are met and if the facts and circumstances do not indicate a contrary result, the IRS will issue an advance letter ruling that the transaction is a lease and that the lessor is the owner for Federal income tax purposes.

The guidelines are not by their terms a definitive statement of legal principles and are not intended for audit purposes. Thus, if all requirements of the guidelines are not met, a transaction might still be considered a lease if, after considering all facts and circumstances, the transaction is a lease under the general principles described above.

The specific requirements for obtaining a ruling under the guidelines are as follows:

1. *Minimum investment.*—The lessor must have a minimum 20 percent unconditional at-risk investment in the property.
2. *Purchase options.*—In general, the lessee may not have an option to purchase the property at the end of the lease term unless, under the lease agreement, the option can be exercised only at fair market value (determined at the time of exercise). This rule precludes fixed price purchase options, even at a bona fide estimate of the projected fair market value of the property at the option date.
3. *Lessee investment precluded.*—Neither the lessee nor a party related to the lessee may furnish any part of the cost of the property.
4. *No lessee loans or guarantees.*—As a corollary to the prior rule, the lessee must not loan to the lessor any of the funds necessary to acquire the property. In addition, the lessee must not guarantee any loan to the lessor.
5. *Profit and cash flow requirements.*—The lessor must expect to receive a profit from the transaction and have a positive cash flow independent of tax benefits.
6. *Limited use property.*—Under Revenue Procedure 76-30, 1976-2 C.B. 647, property that can be used only by the lessee (limited use property) is not eligible for lease treatment.

C. Nontaxable Use Restriction on the Investment Credit

General rule

Property that is "used by" a tax-exempt organization in an exempt function or by a governmental unit generally is ineligible for the investment tax credit (secs. 48(a)(4) and 48(a)(5)). For this purpose, a governmental unit includes the U.S. government, any State or local government, most international organizations, and any instrumentality of the foregoing. A tax-exempt organization is almost any organization exempt from Federal income tax, such as a charitable or educational organization.

To determine whether property is subject to the nontaxable use restriction, it is first necessary to evaluate the economic substance of the transaction under the general principles for determining who is the tax owner of property.[7] Under the nontaxable use restriction the investment credit is unavailable with respect to property that is treated for Federal income tax purposes as being owned by a governmental unit or a tax-exempt organization for use in its exempt function. In addition, it is clear that property leased to a governmental unit or a tax-exempt organization is subject to the nontaxable use restriction. However, in addition to several statutory exceptions to the nontaxable use restriction, one court has held (and the IRS has ruled) that the investment tax credit can be claimed where the governmental unit essentially has contracted for a service, to be provided by the owner of property, rather than for the use of the property itself.

Rationale for the nontaxable use restriction

When the investment credit was enacted in 1962, it was designed to stimulate expansion of the Nation's productive facilities by reducing the net costs of acquiring new equipment. At that time, the restriction on use by a governmental unit was premised on the view that governmental demand for property is not dependent on its price. Thus, a reduction in price, which would, in effect, result if the investment credit were available, would not cause any corresponding increase in production.[8]

The restriction on use by a tax-exempt organization was enacted to prevent an investment credit for property used in a tax-exempt function from reducing the tax attributable to a taxable unrelated trade or business of the organization.

Statutory exceptions to the nontaxable use restriction

Tax-exempt organizations.—Under present law, certain farmers' cooperatives (which are considered exempt from tax even though they are subject to the rules of tax under subchapter T, relating to cooperatives and their patrons) are excluded from the restriction on use by a tax-exempt organization. Also, the credit is allowed for property used by a tax-exempt organization in a taxable unrelated trade or business.

Foreign governmental units.—Although international organizations generally are subject to the restriction, property used by the International Satellite Consortium, the International Maritime Satellite Organization, and any successor organizations, is excluded from the restriction on governmental use. Foreign governments and possessions of the United States are not subject to the restriction. Thus, a computer leased to the U.S. government is denied the credit, but a computer leased to a foreign embassy located in the United States is allowed the credit.

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[7] See, Rev. Rul. 68-590, 1968-2 C.B. 66. Revenue ruling 68-590 involved arrangements between a taxable corporation and a political subdivision of a state, providing for the tax-exempt financing, construction, and operation of an industrial project. The IRS did not apply the nontaxable use restriction, even though the governmental unit held legal title under a sale-and-leaseback. Rather, the IRS held that the corporation was the tax owner of the property. The IRS reasoned that, in view of the economic substance of the arrangement, the sale-leaseback arrangement was nothing more than a security device for the protection of the holders of the tax-exempt bonds.

[8] Somewhat different issues are discussed in part III and in the staff pamphlet "Tax Aspects of Federal Leasing Arrangements" (JCS-3-83.)

Rehabilitated buildings.—Under present law, rehabilitation tax credits are available for qualified rehabilitation expenditures incurred for older buildings leased to tax-exempt organizations or to governmental units.

Foreign persons.—Property used by foreign persons is not subject to the nontaxable use restriction. However, special rules (discussed below) apply if property is used predominantly outside the United States.

"Casual or short-term lease" exception

Under Treasury regulations, there is an exception to the nontaxable use restriction for property that is leased on a "casual or short-term basis." (Treas. Reg. sec. 1.48-1(j) and (k)).

Casual leases.—The term "casual lease" has been interpreted to mean a lease that lacks the formalities inherent in a written lease.[9] Another example of a casual lease might be the lease of an automobile from a car rental company by a governmental employee traveling on governmental business.[10]

Short-term leases.—The exception for short-term leases has been recognized as a means of allowing the government to fulfill an unforeseen or extraordinary need for obtaining the short-term use of property from the private sector, without causing the taxpayer to lose the credit.[11] Thus, property not ordinarily intended for lease to a tax-exempt organization or governmental entity may be leased under the exception for a short period in unforeseen or extraordinary circumstances.

In determining whether the exception for short-term leases applies, the courts have rejected the contention that the relevant consideration is whether the nonqualifying use constitutes a substantial portion of the useful life of the property.[12] The courts have also rejected the position that short-term use should be determined on the basis of the minimum legally enforceable period of a lease.[13]

"Service contract" exception

Internal Revenue Service rulings.—Under Treasury regulations (sec. 1.48-1(j) and (k)), property used by a governmental unit or tax-exempt organization means property owned by or leased to one of those nontaxable entities. In Revenue Ruling 68-109, 1968-1 C.B. 10, the IRS ruled that property provided to a governmental unit as an integral part of a service is not "used by" the government within the meaning of section 48(a)(5).

Revenue Ruling 68-109 involved communications equipment installed by a public utility on the premises of governmental units. In ruling that the taxpayer's agreements with its customers were not sales or leases, but rather service contracts, the IRS relied on the fact that the taxpayer retained all ownership in and possession and control over the equipment. The IRS also focused on the fact that the communications equipment was part of an integrated network used to render services to the customer, not property placed with a user to allow it to provide services to itself.

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[9] See, *Xerox Corporation v. United States*, 656 F.2d 659 (Ct. Cl. 1981).

[10] *Id.*

[11] *World Airways, Inc. v. Commissioner*, 564 F.2d 886 (9th Cir. 1977), *aff'g*. 62 T.C. 786 (1974).

[12] *World Airways Inc. v. Commissioner*, 62 T.C. 786 (1974), *aff'd*, 564 F.2d 886 (9th Cir. 1977).

[13] Thus, the mere fact that a lease contains a cancellation clause will not result in application of this exception. *Xerox Corporation v. United States*, 656 F.2d 659 (Ct. Cl. 1981); *Stewart v. U.S.*, 77-2 U.S.T.C. 9648 (D. Neb. 1977).

The IRS has issued a number of other rulings, including private rulings,[14] interpreting the service contract exception. For example, the investment tax credit has been denied in situations involving trucks operated under a service contract by government employees (Rev. Rul. 72-407, 1972-2 C.B. 10) and school buses operated by a private party under contract with a local school district (LTR 8104001 (February 27, 1980)). However, in LTR 8217040 (January 27, 1982), the IRS allowed the investment tax credit in a situation involving a time charter of a vessel to the Federal government. The IRS ruled that the taxpayer could claim an investment credit for the vessel, based on the taxpayer's representations that the taxpayer bore the risk of loss with respect to the vessel, had to retain possession and control over the vessel, was required to provide maintenance and secure insurance for the vessel, had to furnish and control the crew of the vessel, and that the time charter transferred no legal interest in the property to the Federal government.

The case law.—The only judicial decision dealing with the service contract exception to the nontaxable use restriction is *Xerox Corporation* v. *United States*, 656 F.2d 659 (Ct. Cl. 1981). In *Xerox*, a manufacturer provided duplicating machines to the Federal government. The Internal Revenue Service had issued a revenue ruling involving the same basic facts as in *Xerox* that held that the agreements were leases (Rev. Rul. 71-397, 1971-2 C.B. 63). The Court of Claims rejected the taxpayer's contention that its agreements were short-term leases, which are eligible for an exception to the governmental use restriction. However, the court held that the machines were eligible for the investment credit because they were provided as an integral part of a service contract.

Essentially, the Court of Claims based its decision on the IRS's own formulation of the service contract exception, as set forth in the holdings of published and private rulings (other than Rev. Rul. 71-397, 1971-2 C.B. 63 which reached a contrary result on the same facts considered by the court in *Xerox*). The court rejected the government's contention that the service contract exception cannot ever apply where the customer's own personnel operate the machines, because this factor was present in the first ruling adopting the exception (i.e., Rev. Rul. 68-109, 1968-1 C.B. 10). The court emphasized that *Xerox* was not a case in which the cost or value of the property dominated the price of the total arrangement. The court also noted that, conceivably, its decision would have been different if the Treasury regulations had formulated the precise confines of the service contract exception.

Although the published and private rulings do not articulate any single test for use in determining whether an agreement is a service arrangement or a lease, the court felt that the factors deemed common to service contracts in those rulings related to two broad areas of inquiry: (1) the nature of the possessory interest retained by the taxpayer; and (2) the degree to which the property supplied is a component of an integrated operation in which the taxpayer has other responsibilities.[15]

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[14] Although a private ruling is not binding on the IRS or the courts, a private ruling is helpful in interpreting the law in the absence of other authority.

Finally, in holding that the taxpayer's contractual arrangements could reasonably be deemed to be within the purpose of the investment credit, the court focused on the fact that the taxpayer manufactured machines for all customers not just the government, and that governmental use represented only 5 or 6 percent of the taxpayer's machines.

D. Foreign-use Limitations

Overview

Property "used predominantly outside the United States" is subject to reduced ACRS deductions and is not allowed investment credits (secs. 168(f)(2) and 48(a)(2)).

In general, the term "used predominantly outside the United States" means use outside the United States for more than half of the taxable year. However, there are a number of exceptions to this general rule. For example, communications satellites are excepted from the rules for foreign-use property. U.S.-flag vessels operated in the foreign or domestic commerce of the United States are excepted, as are aircraft registered by the Federal Aviation Agency and operated to and from the United States or operated under contract with the United States, even if operated by a foreign airline.

ACRS deductions

The recovery period for computing ACRS deductions for foreign-use personal property is equal to the present class life (midpoint life) for the property, as of January 1, 1981, under the prior law Asset Depreciation Range (ADR) system. For personal property for which there is no ADR midpoint life as of January 1, 1981, a 12-year recovery period must be used. The determination of useful lives based on facts and circumstances is not permitted. The owner of foreign-use personal property generally is allowed to use the 200-percent declining balance method of depreciation for the early years of the recovery period, and the straight-line method for later years.

For foreign real property (including all components of a building), the recovery period is 35 years. The owner of foreign real property is generally allowed to use the 150-percent declining balance method for the early years of the recovery period, switching to the straight-line method in later years.

In the case of foreign-use personal property or foreign real property, the straight-line method of depreciation can be used in lieu of the prescribed accelerated methods. In addition, for foreign-use personal property, the taxpayer may elect the straight-line method over one of the optional recovery periods allowed for domestic property (but the period elected may not be shorter than the ADR midpoint life, or, for property without an ADR midpoint life as of January 1, 1981, 12 years). For foreign real property, the taxpayer may elect to use the straight-line method over a recovery period of 45 years (instead of 35 years).

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[15] For a more detailed discussion of the court's analysis of these factors, see the pamphlet, "Tax Aspects of Federal Leasing Arrangements" (JCS-3-83), published by the staff of the Joint Committee on Taxation.

III. TAX POLICY ISSUES

Overview

The recent increase in leasing and similar transactions by tax-exempt entities raises a number of tax policy issues. The relative importance of these issues varies according to whether the lessee is a Federal agency, a State or local governmental agency, a nonprofit organization, or a foreign government or person.

Neutrality

One issue is the extent to which economic distortions are created by making the benefits of ACRS deductions, investment credits and deductions for interest expenses available to tax-exempt entities that engage in leasing.

This issue arises because the present tax system can act to subsidize certain investments in buildings and equipment. In the case of equity-financed investments in equipment, the present combination of 3-year or 5-year accelerated cost recovery and the investment tax credit is approximately equivalent to writing off the entire cost of the equipment in the year the asset is placed in service (expensing). Expensing, in turn, is equivalent to a tax exemption for the asset because the present value of the deductions and credits for a taxable investor will be equal to the present value of the income from the asset. Thus, under this analysis, tax-exempt entities have the same incentives to make equity-financed investments in equipment as taxable persons, and the tax system provides no tax incentive for tax-exempt entities to lease, rather than own, equity-financed equipment. In the case of equity-financed purchases of buildings, for which cost recovery deductions are less generous than expensing, there is a positive tax for taxable persons, and tax-exempt entities have both greater incentives to purchase the building than taxable persons and an incentive to own rather than lease it.

However, these results change considerably when the possibility of debt finance is allowed for. For debt-financed investments in equipment, the additional interest deductions mean that the total value of the cost recovery deductions, interest deductions and investment credit to a taxable investor will frequently exceed the tax paid on the income generated by the equipment. In effect, the federal government subsidizes the investment to the extent of this negative tax.[16] Tax-exempt entities are denied this subsidy for the equipment they own and may only receive it by leasing the equipment they use. For buildings owned by taxable persons, which typically are highly leveraged, interest deductions can convert the positive tax on equity-financed structures into a negative tax, so that there can be a tax incentive for tax-exempt entities to lease, rather than own, the buildings they use.

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[16] More precisely, there is a subsidy to the extent that the negative tax exceeds the income tax paid on the interest income received by the lender.

According to one theory, tax subsidies should be made equally available to both taxable and tax-exempt entities. It is argued that this would provide for an efficient allocation of capital between the tax-exempt and taxable sectors. Under this theory, it would be wrong to prevent tax-exempt entities from receiving the benefits of tax incentives through leasing.

However, there are at least two problems with this analysis. First, if one carries to its logical conclusion the notion that taxable and tax-exempt entities should be given equal incentives, it leads to the result that these entities should be treated equally in all respects; that is, that tax-exempt status should be repealed. Second, providing tax-exempt entities with tax benefits through leasing could lead to the curious result that they would eventually lease rather than own most or all of their buildings and equipment.

A second position, embodied in S. 1564, is that the tax benefits available to a tax-exempt lessee ought to be sufficient to produce tax-free financing but not tax-subsidized financing. Then the tax system would be neutral with respect to a tax-exempt entity's decision to lease an asset or to purchase it (with proceeds of tax-exempt bonds), as tax-free financing would result in either case. One way to reduce or eliminate the current potential for subsidy and the tax-driven advantage to leasing over purchasing would be to slow down ACRS deductions for property leased to tax-exempt entities and tighten the various exceptions to the denial of investment tax credit.

Efficiency

The second issue is whether leasing arrangements are an efficient way to provide Federal assistance to tax-exempt entities. Some of the tax benefits in a lease are retained by lawyers, investment bankers, leasing companies, and other agents or investors that are involved in the transaction, instead of being flowed through to the lessee as lower rents. To this extent, leasing may be an inefficient way of assisting tax-exempt entities compared with direct spending programs like general revenue sharing.

Revenue loss

A third issue is the revenue loss to the Treasury. The potential loss from the sale and leaseback of existing buildings could be considerable, and, in the long run, the leasing of new property could impose a comparable revenue cost. In some cases the revenue loss may be justified because of an overriding congressional commitment to a particular policy objective. However, the current tax subsidy for tax-exempt lessees is generally available on an open-ended basis and without limitation to specific cases.

Budget process

A fourth issue is the impact of governmental leasing on the budget process. Under present law, leasing by Federal, State, and local agencies can distort capital and operating budgets at all levels of government. Costs are shifted from the agencies' budgets to the

U.S. Treasury, making it difficult to determine how much Federal assistance is being provided and to whom or for what purposes it is being provided. Lowering the tax incentive for government agencies to lease rather than purchase property would reduce these distortions in the budget process.

Public perceptions

A fifth issue relates to whether the use of tax-motivated arrangements by tax-exempt entities creates perceptions that the tax system is unfair or working badly. This possibility seems especially likely when highly visible assets, such as a city hall or college campus, are offered in sale-leaseback transactions, or when U.S. tax benefits are allowed for assets that are neither produced nor used domestically.

Privatization

A sixth issue has been raised by some who contend that private parties can provide public services more economically than can governments. It is argued that, as leasing is a mechanism for promoting the "privatization" of public services, it should be encouraged. The greater expertise of private providers, as well as their ability to bypass negotiations with public labor unions, requirements of the Davis-Bacon Act, facility design or other criteria specified by public agencies, and delays in obtaining financing through public budgeting processes are among the sources of the cost advantages cited for privatization.

Others take the position that relative expertise in the supply of services is irrelevant in certain leasing transactions, such as sale-leasebacks that do not essentially change the responsibility for providing services. Further, if the tax system provided no special incentive to lease rather than purchase, governmental units would be more likely to lease for reasons of efficiency than tax advantage. Also, critics argue that the Internal Revenue Code ought not be used to supersede laws and procedures which Congress can amend directly upon a full consideration of their merits.

Federal Government

The main issues involved in leasing by Federal government agencies appear to be the distortion of the appropriations process, the potential inefficiency of tax-oriented leases, and the public's perception of the integrity of the Federal tax system. Leasing by a Federal agency distorts the appropriations process by shifting capital acquisition costs from the agency's budget to the Treasury in the form of reduced tax revenues. Thus, it reduces the control over spending normally exercised by the appropriations process by converting direct outlays, which require appropriations, into tax benefits, which do not. Leasing also shifts the disbursement of funds from the agency's procurement account to a possibly less scrutinized part of the budget, such as an operations and maintenance account. When a Federal agency leases, there is no lump sum authorization or annual outlay in the procurement section of the agency's budget; rather, the annual rental payments appear as outlay items as they occur. In addition, leasing may be inefficient and raise the total government cost of acquiring property. Finally, the sale of tax benefits by a Federal government agency, and the indemnification of these benefits against adverse IRS rulings, may contribute to a public perception of inequity in the Federal income tax system.

State and Local Governments

The main tax issue involved in State and local governmental leasing appears to be the extent to which tax benefits originally designed to encourage private sector capital formation should provide assistance to State and local governments.

Congress already provides assistance through the tax system to State and local governments by means of the exclusion from Federal tax of interest paid on municipal bonds and the itemized deduction for most State and local taxes. The 1983 combined cost to the Treasury of these items is expected to exceed $45 billion. Leasing increases the amount of assistance that State and local governments receive through the tax system, especially where it is done because bond issues have been rejected or limits on indebtedness have been reached.

In some instances, State and local governments combine the benefits of leasing and tax-exempt debt in the same transaction. In these transactions, industrial development bonds (IDBs) are issued to finance the sale of public property to the lessor. The proceeds of the sale may then be invested by the State or local government in taxable bonds, the interest on which is used to cover rental payments, meet other current expenses, and establish a sinking fund for repurchasing the property. Such arrangements may not be subject to the anti-arbitrage rules which prohibit the issuance of tax-exempt bonds for the purpose of purchasing taxable securities yielding a higher rate of return.

Relative to the Federal government, State and local governments spend a larger proportion of their budgets on the direct provision of public services and a smaller proportion on transfer payments. Thus, the relative importance of the privatization issue would appear to be greater at the State and local governmental levels.

Finally, the potential revenue cost of sale-leasebacks appears to be very large due to the dollar value of the property currently owned by State and local governments.

Nonprofit Organizations

Leasing by nonprofit organizations generally raises similar tax policy issues as State and local governmental leasing. By selling its real estate and leasing it back, a nonprofit organization, in effect, borrows money at a very low cost because the lessor receives part of its return from tax benefits. The nonprofit organization can then reinvest the proceeds in securities and effectively earn an arbitrage profit from the Federal government.

Congress currently provides other assistance to nonprofit organizations through the tax system. For example, the cost to the Treasury of deductions of charitable contributions is expected to exceed $9 billion in 1983.

Foreign Governments and Persons

As is the case with any other lessee, a foreign person leasing property from a U.S. lessor may receive an indirect tax subsidy from the U.S. Treasury. If the foreign person is taxable by the United States on all the income generated by that property, the subsidy is as justifiable as that provided to any other taxable user. However, if only a very small proportion of the income is taxable by the United States, or if the foreigner is not subject to U.S. tax because it is a foreign government or a foreign entity not doing business in the U.S., then many of the same issues as are described above are raised.

For U.S.-produced goods, the subsidy for foreign investment might be justified as an export incentive. However, no similar justification exists where foreign-produced goods are leased. A related issue is the potential revenue cost if foreigners are able to take unrestricted advantage of U.S. tax subsidies by leasing property from U.S. lessors.

IV. DESCRIPTION OF THE BILL

Explanation of Provisions

Overview

In general, S. 1564 would reduce the tax benefits that would be otherwise available for property used by tax-exempt entities, with exceptions for certain short-lived property, certain real property and property subject to short-term leases. The bill would define the term "tax-exempt entity" to include Federal, State, local, and foreign governments, possessions of the United States, international organizations, certain instrumentalities of the foregoing, and certain foreign persons, as well as most organizations that are exempt from Federal income tax.

The bill would also provide criteria for use in determining whether an arrangement that is structured as a service contract should be treated as a lease. However, the bill would create no inferences regarding the present-law treatment of purported service contracts under the nontaxable use restrictions on the investment credit. Under certain circumstances, the rehabilitation credit would be denied for real property that is leased to a tax-exempt entity.

The present law rules for determining the tax owner of property would be undisturbed. Thus, the bill would leave open the possibility that a tax-exempt entity could be treated as the owner of property. As under present law, if a tax-exempt entity were considered the owner, generally no tax benefits would be available with respect to the property. Again, however, the bill would create no inferences regarding who should be treated as the owner of property involved in a transaction that is subject to the bill or would have been subject to the bill but for its effective date provisions.

Depreciation

Reduced deductions.—In the case of "tax-exempt use property" (defined below), accelerated cost recovery (ACRS) deductions and any other deduction allowable for depreciation or amortization would be computed by using the straight-line method and disregarding salvage value. The recovery period for tax-exempt use property in the 15-year real property class would be 40 years or 125 percent of the term of the lease, whichever is greater. The recovery period for all other tax-exempt use property would equal the midpoint life of the property as of January 1, 1981, under the Asset Depreciation Range (ADR) system or 125 percent of the term of the lease, whichever is greater. Personal property that has no ADR life would be treated as having a midpoint life of 12 years. For purposes of applying these rules, the term of a lease would include any period for which the lease may be renewed or extended at the lessee's option.

If a taxpayer elects under ACRS to recover the cost of property over an optional recovery period that exceeds the recovery period prescribed by the bill, then the cost of the property would be recovered over the longer period.

For property other than 15-year real property, the half-year convention used under prior-law depreciation rules would apply. For 15-year real property, first-year deductions would be determined on the basis of the number of months in the year in which the property is in service.

Investment tax credits

Overview.—As under present law, the investment credit generally would be denied for property leased to or otherwise used by a tax-exempt entity. However, the present-law nontaxable use restriction would be modified by expanding the category of tax-exempt entities subject to the restriction and by providing guidelines for distinguishing a service contract from a lease (see discussion of tax-exempt use property below).

The present-law exception to the nontaxable use restriction for short-term or casual leases would be replaced with an objective short-term lease exception (described below).

Rehabilitation credits.—Expenditures attributable to the rehabilitation of the portion of a building that is (or may reasonably be expected to be) tax-exempt use property would be excluded from the definition of qualified rehabilitation expenditures eligible for the investment credit. The excluded expenditures would not be taken into account in determining whether there is a substantial rehabilitation of the building.

If the building with respect to which a rehabilitation credit was allowed were to become tax-exempt use property, the portion of the building that constitutes tax-exempt use property would be treated as having been disposed of at the time such property becomes tax-exempt use property. Thus, for example, if an entire qualified rehabilitated building becomes tax-exempt use property more than one but less than two years after the close of the year in which the building was placed in service, 80 percent of the rehabilitation credit would be recaptured. On the other hand, if the building becomes tax-exempt use property after five full years have passed, the credit would not be recaptured.

Tax-exempt use property

General rule.—For the depreciation and investment credit provisions of the bill, tax-exempt use property (other than 15-year real property) would include property leased to or otherwise used by a tax-exempt entity.

Exception for certain short-lived property.—Property with a midpoint life of six years or less would be excluded from the depreciation provisions of the bill, but only where the term of the lease to which such property is subject is 75 percent or less of the property's midpoint life.

Real property.—15-year real property would be treated as tax-exempt use property only to the extent that all or a portion of the property is leased to or otherwise used by a tax-exempt entity, and only if more than 50 percent of the use of the property consists of use described in at least one of the following circumstances:

(1) The property was financed in whole or in part by obligations the interest on which is exempt from Federal income tax under Code section 103 and the tax-exempt entity (or a related party) participated in such financing;

(2) Such use is pursuant to a lease containing a fixed-price purchase option exercisable by the tax-exempt entity (or a related entity), or a sale option under which the lessor can require such an entity to purchase the property (e.g., a put);

(3) Such use occurs after a sale-leaseback or lease-leaseback of the property by the tax-exempt entity (or a related entity); or

(4) Such use is pursuant to a lease the term of which is greater than 10 years.

For example, the provisions of the bill would apply if a municipality leases 75 percent of a building, the construction of which was financed in whole or in part with tax-exempt bonds issued by the municipality (or a related entity), but only to the extent of 75 percent of the cost of the property.

Short-term lease exceptions.—For purposes of both the depreciation and the investment credit provisions, tax-exempt use property would not include personal property leased for a term that is less than one year or 30 percent (up to a maximum of three years) of the property's midpoint life, whichever is greater. In the case of 15-year real property, tax-exempt use property would not include property leased for a term that is less than three years (one year in the case of a qualified rehabilitated building or portion thereof).

Exception for property used in a taxable activity.—Tax-exempt use property would not include any portion of property that is used predominantly in a tax-exempt entity's unrelated trade or business, where the income from such trade or business is subject to tax under section 511.

Treatment of renewal options.—In determining whether property is tax-exempt use property the bill would require the term of the lease to be computed by including any period for which the lease may be renewed, extended, or continued pursuant to an option exercisable by the lessee. A technical amendment is necessary to make clear that this rule applies to the investment tax credit provisions of the bill.

For example, the provisions of the bill would apply if equipment with a midpoint life of seven years is leased for a two-year term subject to the lessee's option to renew the lease for another two years, even at the then fair rental value, regardless of whether the lease is in fact renewed.

Service contracts.—In determining whether a transaction structured as a service contract should be treated as a lease, the bill would require that all relevant factors be taken into account, including:

(1) Whether the tax-exempt entity controls or is in physical possession of the property;

(2) Whether the tax-exempt entity has a significant possessory or economic interest in the property; and

(3) Whether the service provider (a) bears any substantial risk of loss from nonperformance, or (b) concurrently uses the property to provide services to taxable entities.

For example, a transaction structured as a service contract would be treated as a lease or other use if all of the following factors were present:

(1) Employees of the tax-exempt entity operate or assist in the operation of the property,

(2) The property is dedicated solely to the tax-exempt entity for a substantial portion of the useful life of the property,

(3) The cost or value of the property itself dominates the price of the total arrangement,

(4) The tax-exempt entity bears the risk that the property will decline in value (*e.g.*, if the entity terminates the contract prematurely and is required to make up any difference between the then fair market value and an amount approximating the owner's unrecovered equity, remaining debt, and tax liability incurred), and

(5) The tax-exempt entity bears the risk of damage to or loss of the property.

On these facts, the tax-exempt entity may be considered the owner of the property under the general principles of Federal income tax law. If, however, the service provider were considered the tax owner, the tax-exempt entity would be treated as using the property under the bill. Thus, in either case, the property would be tax-exempt use property.

Definition of tax-exempt entity

In general, the bill would define "tax-exempt entity," for purposes of the depreciation and investment credit rules, as (1) the United States, any State or political subdivision thereof, any possession of the United States, any foreign government, any international organization (including the International Telecommunication Satellite Consortium and the International Maritime Satellite Organization, or any successor organization), or any agency or instrumentality of the foregoing; (2) any organization (other than certain farmers' cooperatives) that is exempt from U.S. income taxation; and (3) any foreign person. However, the term "tax-exempt entity" would include an agency or instrumentality of a government or international organization, or a foreign person, only with respect to property 20 percent or less of the income derived from which is subject to U.S. tax. For example, the bill would apply to an aircraft leased to a foreign person unless more than 20 percent of the income derived from the use of the aircraft is subject to U.S. tax. This conclusion would be the same even if the aircraft is registered by the Administrator of the Federal Aviation Agency and operated to and from the United States or operated under a contract with the United States. A foreign person would be a tax-exempt entity if it were exempt from U.S. tax by virtue of an income tax treaty or other bilateral agreement.

Effective Date

Except as otherwise provided, the provisions of the bill would apply to property placed in service by the taxpayer after May 23, 1983.

Binding contracts.—The provisions of the bill would not apply to any property that is used by a tax-exempt entity pursuant to one or more written contracts if (1) such contract or contracts were binding on May 23, 1983 and at all times thereafter, (2) such contract or contracts required the taxpayer (or a predecessor in interest under the contract) to acquire, construct, reconstruct, or rehabilitate such property, and (3) such contract or contracts required the tax-exempt entity (or a related entity) to use the property. However, in the case of property used by the United States, or an agency or instrumentality thereof that is subject to the bill, the transitional rule for binding contracts would not apply unless the property were also placed in service before January 1, 1984. The definition of a tax-exempt entity for purposes of this binding contract rule would be the same as for the investment credit and depreciation provisions in the bill.

Mass commuting vehicles.—The provisions of the bill would not apply to any qualified mass commuting vehicle (as defined in section 103(b)(9)), which is financed in whole or in part by obligations the interest on which is exempt from tax under section 103(a) if (1) the vehicle is placed in service before January 1, 1988 or (2) the vehicle is placed in service after that date because of conditions not within the control of the lessor or the lessee and there was a binding contract or commitment entered into before April 1, 1983, for the acquisition or construction of the property. For this purpose, a binding commitment would include bids that have been accepted by a transit system but that may be challenged by third parties. In addition, change orders that would not affect the substance of a contract or commitment would be permitted.

Comparison with H.R. 3110

H.R. 3110, introduced by Congressman Pickle and other cosponsors, contains provisions relating to tax-exempt use property which are similar to those of S. 1564. A public hearing was held on H.R. 3110 before the Committee on Ways and Means on June 9, 1983.[17] The principal differences between the two bills are summarized below.

Recovery period.—Under H.R. 3110, ACRS (or depreciation) deductions would be computed over the following extended recovery periods: 5 years for property in the 3-year ACRS class, 12 years for property in the 5-year ACRS class, 25 years for property in the 10-year ACRS class, and 35 years for property in the 15-year public utility or real property ACRS class. Under S. 1564, the recovery period would be the ADR midpoint life (40 years for property in the 15-year real property ACRS class) or 125 percent of the lease term, whichever is greater.

Short-term lease exception.—H.R. 3110 would provide a short-term or casual lease exception determined under a facts-and-circumstances test. The exception under S. 1564 would be based on a length-of-lease test.

Short-lived personal property.—H.R. 3110 does not contain an exception for the short-lived personal property that would be excepted from the definition of tax-exempt use property under S. 1564.

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[17] See also Joint Committee staff pamphlet, "Description of H.R. 3110 Relating to Tax Treatment of Property used by Nontaxable Entities" (JCS–21–83).

15-year real property.—The circumstances under which the two bills would apply to real property are substantially similar. However, H.R. 3110 does not include a provision for long-term leases. H.R. 3110 would apply where a tax-exempt entity protects the lessor from loss on its investment. Finally, H.R. 3110 would apply only if more than 20 percent (50 percent under S. 1564) of the property is used under circumstances described in the bill.

Service contracts.—The two bills would provide different (nonexclusive) factors to be taken into account for determining whether a service contract is more properly treated as a lease.

Rehabilitation credit.—H.R. 3110 would deny the rehabilitation credit if any portion of the cost of acquiring or rehabilitating a building was financed with industrial development bonds. S. 1564 would deny this credit for tax-exempt use property.

Definition of tax-exempt entity.—H.R. 3110 would not except instrumentalities of governmental units or international organizations that are subject to U.S. tax from the definition of tax-exempt entity. Also, H.R. 3110 would except any foreign person with respect to property the income from use of which is subject to U.S. tax, with no requirement that a minimum percentage of the income be subject to tax.

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[Press Release No. 83-154]

Finance Committee Sets Hearings on Governmental Lease Financing Reform Act

Senator Robert J. Dole (R., Kans.), Chairman of the Senate Committee on Finance, announced today that the Committee will hold hearings on Tuesday, July 19, 1983, on S. 1564, the Governmental Lease Financing Reform Act of 1983, introduced by Senators Dole, Metzenbaum, Durenberger, and Grassley.

The hearing will begin at 9:30 a.m. on July 19, 1983, in Room SD-215 of the Dirksen Senate Office Building.

Opening Statement of Senator Dole

I am pleased to convene this hearing on S. 1564, the Governmental Lease Financing Reform Act of 1983. This bill has been co-sponsored by Senators Metzenbaum, Durenberger, and Grassley, and has a substantially similar companion bill in the House. In testimony before the Ways and Means Committee last month, the Treasury Department generally supported H.R. 3110, but identified a number of problem areas and made some suggestions for revision. We took most of these suggestions when we drafted S. 1564. Accordingly, to the extent the Treasury Department testimony is consistent with their House testimony, I expect strong support. To the extent the Treasury has rethought their position on these important questions, I look forward to discussing those changes with them.

THE FUNDAMENTAL PRINCIPLE OF S. 1564

A review of many of the statements shows that many have misunderstood S. 1564. It is not a bill aimed against State and local governments. It is not a bill aimed at the Navy. All S. 1564 says is that tax exempt entities may not trade on their tax exemption by selling their tax deductions or credits. To permit such sales would permit negative tax rates. Tax exemption for charitable organizations, foreign persons, and governmental units is as far as we should go. Negative tax rates are neither desirable nor appropriate.

I look forward to discussing with the witnesses who will argue in favor of the continued sale of the tax benefits why, with a $200 billion or more deficit and a budget that calls for $73 billion in tax increases over the next three years, we should provide any sector of the economy with a negative effective tax rate.

PROCEDURE

I want to note briefly a change in committee procedure. In order to expedite this hearing and to make it more instructive for members of the committee, we have adopted a new format today. Witnesses' written statements will all be made a part of the record in their entirety. Oral statements will be limited to one minute. To the extent that witnesses have complied with the 48 hour rule and supplied copies of their statements to the committee for study, we will probably have questions. To the extent that witnesses have failed to comply and we have not had an opportunity to study the written statements, we may submit further questions in writing.

Our first witness is Senator Metzenbaum.

Opening Statement of Senator Grassley

Mr. Chairman, I commend the Committee and its chairman for scheduling hearings on this growing problem.

As a co-sponsor of the measure before the committee, I think it merits swift enactment. The Internal Revenue Code bestows tax exemption on a small, select group of taxpayers who are organized to accomplish a Congressionally-sanctioned purpose. It also gives tax exemption to other units of government. Short of refundability, tax exemption is the most generous tax benefit given to any class of taxpayers.

Recently, tax exempt entities have sold and leased back their facilities to generate additional revenues. What are they selling? They are selling the tax preference items associated with the asset to taxpayers who are taxable. In essence, they are marketing tax shelters.

As Chairman of the Subcommittee on Oversight of the IRS, I recently held a hearing on tax shelters and the efforts of Treasury and the IRS to stop their proliferation. As Congress is attempting to broaden the revenue base, it seems unfair to permit tax exempt taxpayers to accelerate the erosion of our current revenue base, causing Congress to increase the taxes of taxable individuals.

Also, I object to the use of sale/leaseback transactions to transfer tax benefits. I oppose this mechanism for tax-exempt as well as taxable taxpayers because I think it enables tax benefits to be scattered throughout the economy without Congressional control. The use of sale/leaseback transactions by tax exempt taxpayers has been estimated to cost billions of dollars in lost revenue to the federal Treasury. Like safe-harbor leasing, Congress has retained no control as to who receives these benefits. We are rewarding aggressive tax-exempt entities who may be no more or less worthy than the less aggressive merely because they are aggressive, not because they have been forced to set priorities with a finite amount of revenue. This kind of unlimited availability to federal benefits is characteristic of entitlement programs, a source of great concern to many of us here in Congress. If our budget crisis is ever to be resolved, this type of spending approach must be stopped.

To conclude, while state and local governments and educational organizations are certainly worthy recipients of federal support, I question the use of this funding mechanism to assist them. I look forward to the comments of the witnesses on this legislation and commend the Chairman for his swift attention to this problem.

II

98TH CONGRESS
1ST SESSION

S. 1564

To amend the Internal Revenue Code of 1954 to deny certain tax incentives for property used by governments and other tax-exempt entities.

IN THE SENATE OF THE UNITED STATES

JUNE 29 (legislative day, JUNE 27), 1983

Mr. DOLE (for himself, Mr. METZENBAUM, Mr. DURENBERGER, and Mr. GRASSLEY) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to deny certain tax incentives for property used by governments and other tax-exempt entities.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Governmental Lease Financing Reform Act of 1983".

SEC. 2. DENIAL OF TAX INCENTIVES FOR PROPERTY USED BY GOVERNMENTS AND OTHER TAX-EXEMPT ENTITIES.

(a) GENERAL RULE.—Subsection (f) of section 168 of the Internal Revenue Code of 1954 (relating to special rules for application of accelerated cost recovery system) is amended by redesignating paragraph (13) as paragraph (14) and by inserting after paragraph (12) the following new paragraph:

"(13) PROPERTY USED BY GOVERNMENTS AND OTHER TAX-EXEMPT ENTITIES.—

"(A) IN GENERAL.—Notwithstanding any other provision of this section, the deduction allowed under subsection (a) (and any other deduction allowable for depreciation or amortization) for any taxable year with respect to tax-exempt use property shall be determined—

"(i) by using the straight-line method (without regard to salvage value), and

"(ii) by using a recovery period equal to the greater of—

"(I) the present class life of such property (40 years in the case of 15-year real property), or

"(II) in the case of property subject to a lease, a period equal to 125 percent of the term of the lease.

"(B) OPERATING RULES.—

"(i) CONVENTION.—In the case of property other than 15-year real property, the half-year convention shall apply for purposes of subparagraph (A). In the case of 15-year real property, the amount determined under subparagraph (A) shall be determined on the basis of the number of months in the year in which the property is in service.

"(ii) EXCEPTION WHERE LONGER RECOVERY PERIOD APPLICABLE.—Subparagraph (A) shall not apply to any recovery property if the recovery period which would be applicable to such property by reason of an election under subsection (b)(3) exceeds the recovery period for such property determined under subparagraph (A)(ii).

"(iii) SPECIAL RULE FOR PROPERTY WHICH IS NOT RECOVERY PROPERTY.—In the case of any property which is not recovery property, for purposes of this paragraph, the determination of the class in which such property falls shall be made as if such property were recovery property.

"(iv) COORDINATION WITH PARAGRAPH (12).—Paragraph (12) shall not apply to any property to which this paragraph applies.

"(v) PROPERTY WITH NO PRESENT CLASS LIFE.—For purposes of subparagraph (A)(ii)(I), property with no present class life shall be treated as having a present class life of 12 years.

"(C) TAX-EXEMPT USE PROPERTY.—For purposes of this paragraph—

"(i) IN GENERAL.—Except as otherwise provided in this paragraph, the term 'tax-exempt use property' means any property used by a tax-exempt entity.

"(ii) EXCEPTION FOR SHORT-TERM LEASES OF PERSONAL PROPERTY.—For purposes of clause (i), property (other than 15-year real property) shall not be treated as used by a tax-exempt entity if such entity leases such property under a lease the term of which is less than the greater of—

"(I) 1 year, or

"(II) 30 percent of the present class life of such property, but not in excess of 3 years.

"(iii) EXCEPTION FOR SHORT-LIVED PROPERTY.—For purposes of clause (i), the term 'tax-exempt use property' shall not include property with a present class life of 6 years or less but only if the term of the lease to which such property is subject is 75 percent or less of such present class life.

"(iv) 15-YEAR REAL PROPERTY.—In the case of 15-year real property, the term 'tax-exempt use property' means any property to the extent used by a tax-exempt entity where—

"(I) the property was financed in whole or in part by obligations the interest on which is exempt from tax under section 103 and such entity (or a related entity) participated in such financing,

"(II) such use is pursuant to a lease under which there is a fixed price purchase or sale option which involves such entity (or a related entity), "(III) such use occurs after a sale or lease of the property by such entity (or a related entity) and a leaseback, or

"(IV) such use is pursuant to a lease the term of which is greater than 10 years.

Such term shall not include any property (or portion thereof) unless more than 50 percent of the use of such property consists of use described in the preceding sentence. Such term shall not include any property (or portion thereof) subject to a lease the term of which is less than 3 years (1 year in the case of a qualified rehabilitated building or portion thereof, as defined in section 48(g)(1)).

"(v) EXCEPTION WHERE PROPERTY USED IN UNRELATED TRADE OR BUSINESS.—The term 'tax-exempt use property' shall not include any portion of a property predominantly used by the tax-exempt entity in an unrelated trade or business the income of which is subject to tax under section 511.

"(D) OPTION TO RENEW, ETC.—For purposes of this paragraph, the term of a lease shall include any period for which the lease may be renewed, extended, or continued pursuant to an option exercisable by the lessee.

"(E) TAX-EXEMPT ENTITY.—For purposes of this paragraph, the term 'tax-exempt entity' means—

"(i) the United States, any State or political subdivision thereof, any possession of the United States, any foreign government, any international organization,

"(ii) an organization (other than a cooperative described in section 521) which is exempt from tax imposed by this chapter, and

"(iii) any person who—

"(I) is not a United States person, or

"(II) is an agency or instrumentality of an entity described in clause (i),

but only with respect to property 80 percent or more of the income derived from the use of which is not subject to tax under this chapter.

"(F) TREATMENT OF CERTAIN CONTRACTS FOR PROVIDING SERVICES.—For purposes of this paragraph and determining the amount of the credit (if any) allowable under section 38, in determining whether a contract involving a tax-exempt entity which purports to be a service contract shall be treated as a service contract or as a lease of property, the Secretary shall take into account all relevant factors, including whether or not—

"(i) such entity controls or is in physical possession of the property,

"(ii) such entity has a significant possessory or economic interest in the property, and

"(iii) the service provider—

"(I) bears any substantial risk of loss from nonperformance, or

"(II) concurrently uses such property to provide services to taxable entities.".

(b) DENIAL OF INVESTMENT TAX CREDIT FOR PROPERTY USED BY FOREIGN GOVERNMENTS AND OTHER FOREIGN PERSONS; ALLOWANCE OF CREDIT IN CASE OF SHORT-TERM LEASES.—

(1) FOREIGN GOVERNMENTS AND PERSONS.—Paragraph (5) of section 48(a) of such Code (relating to property used by governmental units) is amended by

striking out the first sentence and inserting in lieu thereof the following: "Property used—

"(A) by the United States, any State or political subdivision thereof, any possession of the United States, any foreign government, or any international organization, or

"(B) by any person who—

"(i) is not a United States person, or

"(ii) is an agency or instrumentality of an entity described in subparagraph (A),

but only with respect to property 80 percent or more of the income derived from the use of which is not subject to tax under this chapter,

shall not be treated as section 38 property.".

(2) CREDIT ALLOWED IN CASES OF SHORT-TERM LEASES.—

(A) IN GENERAL.—Section 48(a) of such Code (defining section 38 property) is amended by adding at the end thereof the following new paragraph:

"(11) SPECIAL RULES FOR APPLICATION OF PARAGRAPHS (4) AND (5).—

"(A) QUALIFIED REHABILITATION EXPENDITURES.—If any qualified rehabilitated building is used by a tax-exempt organization or governmental unit pursuant to a lease, paragraphs (4) and (5) shall not apply to that portion of the basis of such building which is attributable to qualified rehabilitation expenditures.

"(B) Short-term leases.—Paragraphs (4) and (5) shall not apply to property used by a tax-exempt organization or governmental unit under a lease the term of which is less than the greater of—

"(i) 1 year, or

"(ii) 30 percent of the present class life (within the meaning of section 168(g)(2)) of such property, but not in excess of 3 years.".

(B) Conforming amendments.—Paragraphs (4) and (5) of section 48(a) of such Code are each amended by striking out the last sentence thereof.

(c) Rehabilitation Credit Not To Apply to Tax-Exempt Use Property.—

(1) In general.—Subparagraph (B) of section 48(g)(2) of such Code (relating to certain expenditures not treated as qualified rehabilitation expenditures) is amended by adding at the end thereof the following new clause:

"(vi) TAX-EXEMPT USE PROPERTY.—That portion of any expenditures in connection with the rehabilitation of a building which are allocable to that portion of such building which is (or may reasonably be expected to be) tax-exempt use property (within the meaning of section 168(f)(13)(C)).".

(2) RECAPTURE.—Section 47(a) of such Code (relating to certain dispositions, etc., of section 38 property) is amended by adding at the end thereof the following new paragraph:

"(9) SPECIAL RULE FOR TAX-EXEMPT USE PROPERTY.—

"(A) IN GENERAL.—If any qualified rehabilitated building with respect to which a rehabilitation investment credit was allowed becomes tax-exempt use property, then—

"(i) such property shall, for purposes of this subsection, be treated as disposed of in the taxable year in which such property became tax-exempt use property, but

"(ii) this subsection shall only be applied with respect to the rehabilitation investment credit.

"(B) TAX-EXEMPT USE PROPERTY DEFINED.—For purposes of this paragraph, the term 'tax-exempt use property' means property described in section 168(f)(13)(C).".

(3) Technical amendment.—Clause (i) of section 48(g)(2)(B) of such Code is amended by adding at the end thereof the following new sentence: "The preceding sentence shall not apply to any expenditure to the extent paragraph (12) or (13) of section 168(f) applies to such expenditure.".

(d) Effective Dates.—

(1) In general.—Except as otherwise provided in this subsection, the amendments made by this section shall apply to property placed in service by the taxpayer after May 23, 1983, in taxable years ending after such date.

(2) Binding contracts.—The amendments made by this section shall not apply with respect to any property used by a tax-exempt entity if such use is pursuant to one or more written binding contracts which on May 23, 1983, and at all times thereafter, required—

(A) the taxpayer (or his predecessor in interest under the contract) to acquire, construct, reconstruct, or rehabilitate such property, and

(B) the tax-exempt entity (or a related entity) to use such property.

In the case of any property used by the United States or an agency or instrumentality thereof, the preceding sentence shall apply only if such property is placed in service by the taxpayer before January 1, 1984.

(3) MASS COMMUTING VEHICLES.—The amendments made by this section shall not apply to any mass commuting vehicle which is property which is described in section 208(d)(5) of the Tax Equity and Fiscal Responsibility Act of 1982 applies.

(4) TAX-EXEMPT ENTITY AND RELATED ENTITY DEFINED.—For purposes of this subsection, the terms "tax-exempt entity" and "related entity" have the respective meanings given such term, by section 168(f)(13) of the Internal Revenue Code of 1954, as added by this section.

The **Chairman**. Let me say, first of all, I am pleased to convene this hearing on S. 1564, the Governmental Lease Financing Reform Act of 1983. This bill has been cosponsored by Senators Metzenbaum, Durenberger, and Grassley, and it has a substantially similar companion bill in the House.

In testimony before the Ways and Means Committee last month, the Treasury Department generally supported H.R. 3110 but identified a number of problem areas and made some suggestions for revision.

We took most of these suggestions when we drafted S. 1564. Accordingly, to the extent that the Treasury Department testimony today is consistent with its House testimony, I expect strong support. To the extent that Treasury has rethought their position on these important questions, we look forward to discussing any changes with them.

A review of many of the statements shows that many have misunderstood S. 1564. It is not a bill aimed against State and local governments, it is not a bill aimed at the Navy; all S. 1564 says is that tax-exempt entities may not trade on their tax exemption by selling their tax deductions or credits. To permit such sales would be to permit negative tax rates.

Tax exemption for charitable organizations, foreign persons, and governmental units is as far as we should go. Negative tax rates are neither desirable nor appropriate.

I look forward to discussing with the witnesses who will argue in favor of the continued sale of the tax benefits why, with a $200 billion or more deficit in the budget that calls for $73 billion in tax increases over the next 3 years, we should provide any sector of the economy with a negative effective tax rate.

I want to note briefly a change in committee procedure. In order to expedite this hearing and to make it more instructive for members of the committee, we have adopted a new format. We are going to try it and see if it works. If so, we will use it later.

Witnesses' written statements will all be made a part of the record in their entirety. Oral statements will be limited to 1 minute. To the extent that witnesses have complied with the 48-hour rule and supplied copies of their statements to the committee for study, we will probably have questions. To the extent that witnesses have failed to comply and we have not had an opportunity to study the written statements, we may submit further questions in writing.

I might suggest, we are trying to find some way to have a better hearing record and also to make certain those who end up at the end of a hearing list in every committee have a chance to be heard, rather than be asked that their statements be made a part of the record.

As usual, we have probably more witnesses than we need—I think I count 18—and I'm not certain how many members will be at this hearing, but this Senator has to leave at 11:45. So we are going to try to accommodate the witnesses who have traveled long distances—the Government witnesses we have access to—and we hope that we can speed up the process and still make a hearing record. If there is only one Senator here, it doesn't enlighten me much to have you read to me for 10 or 15 minutes.

So our first witness is Senator Metzenbaum.

STATEMENT OF HON. HOWARD M. METZENBAUM, U.S. SENATOR FROM THE STATE OF OHIO

Senator **METZENBAUM**. Mr. Chairman, I understand the pressure of time that you are under, and I, too, am going to shorten my remarks, because frankly I don't think I am speaking to you. You are the cosponsor of the bill.

The **CHAIRMAN**. Right.

Senator **METZENBAUM**. And I am a realist enough to recognize that it's 9:30 in the morning, and no other members of the committee are here.

The **CHAIRMAN**. I don't see too many, no.

Senator **METZENBAUM**. Mr. Chairman, you have a difficult job, and yet I think the American people have a difficult job.

The American people have been saying for years that they want a balanced budget, and they have been saying that we in the Congress have an obligation to provide them with a balanced budget. The President of the United States has addressed himself to that issue, both as a candidate and as the President.

Mr. Chairman, it's disheartening, and I am frank to say to you that if you had some tax reduction items before this committee today, you would have members here, all of them looking out for their particular interests. But when it comes to biting the bullet and doing something about closing some of the tax loopholes, no matter how egregious they may be, nobody wants to do that around these Halls—with some exceptions, and you are notably one of them.

Mr. Chairman, I must tell you that every day I get letters in the mail from the very people who have been pounding at my door for years to cut spending, balance the budget, don't give away the money of the Treasury, fight inflation. The farm bureau or the Manufacturers Association, the labor unions, and now the cities and the counties, and the charitable organizations, and the historic museums—all of them are now coming forward telling us what a right thing it is to have the kind of tax loopholes that exist in the law today.

Look at them: Sunnyvale Public Library and Air Force jets all being leased on special kinds of tax gimmicks. The Takoma Pantages Performing Art Center—I will guarantee, and I don't know the board of that body, but I will guarantee that every one of them, almost with no exception, is a conservative who has been talking about balancing the budget for years. Oakland Museum—the same goes for them. Now they are talking about the Clinch River breeder reactor, and the Atlanta City Hall. How absurd can we get? The Philadelphia Public School System.

Mr. Chairman, if I sound exercised it's because I am exercised. It's frustrating. Everyone comes holier than thou, and they are going to appear before you today holier than thou to tell you what a wonderful thing it is to have this special kind of tax gimmick. As a matter of fact, according to an article in the Urban Conservation Report of October 18, 1982, "According to real estate development experts, sale leasebacks may be the tax shelter of the 1980's. I predict a surge in public use of this tool"—Donald Hunter, a development consultant was quoted as saying that.

And the ranking minority member has stated it well: "When we have the problem of tax loopholes or raising moneys as far as tax revenues are concerned," his quote is so applicable: "Don't tax you, don't tax me; tax the fellow behind the tree." And he's right on target.

Unless you in your committee do something on this subject, the Treasury of the United States is going to lose billions of dollars.

I am not interested in the pleas of the cities and the counties and the school boards who are saying that they need it. I agree with them. They have no stronger advocate in the U.S. Senate than I as far as their needing additional funding to do their job. But don't do through the back door what you can't do through the front door. And frankly, if you do it through the back door, it's a hell of a lot more expensive to do it that way.

Four hundred and fifty investors bought into the Continental Corp.'s New York City office tower. The middlemen will collect $36 million, or 26 percent of the $137.3 million in cash invested—$36 million for the middlemen.

Now, I don't blame these people for going in these tax shelters. I don't blame the cities for coming in and trying to do what they are doing. I don't blame anybody else—I blame us. The buck stops with us. And unless this committee and this Congress does something to close gaping loophole that exists in the law at the moment, it is we who will be remiss.

I hope, Mr. Chairman, that your committee will see fit to act with dispatch. I am pleased to have joined with you and Senators Durenberger and Grassley as sponsors of this legislation; but I recognize that it is an uphill battle, because the special interests will not quit working.

I pledge to you that I will do everything in my power to help you with this legislation.

I ask unanimous consent that my entire statement be included in the record.

The **Chairman**. Thank you very much, Senator Metzenbaum, and thank you for the early work in putting the package together.

We did have a visit, as you know, in your office with Congressman Pickle just last week, and I understand he intends to move ahead.

This is an area that, if we don't do something, we are looking at conservative estimates of a $15 billion loss to the Treasury, over the next 5 years, and that's substantial.

Senator **Metzenbaum**. And I think that's conservative, frankly, Mr. Chairman.

The **Chairman**. There are different estimates.

Senator Long, do you have a question?

Senator **Long**. No questions.

The **Chairman**. Thank you very much.

Senator **Metzenbaum**. I thank you, Mr. Chairman.

[The prepared statement of Senator Metzenbaum follows:]

TESTIMONY OF SENATOR HOWARD M. METZENBAUM BEFORE THE SENATE FINANCE COMMITTEE ON S. 1564 "THE GOVERNMENTAL LEASE FINANCE REFORM ACT OF 1983"—JULY 19, 1983

Mr. Chairman, I compliment you and the Committee for moving so expeditiously on S. 1564, the "Governmental Lease Financing Reform Act of 1983." I am pleased that Senators Durenberger and Grassley are joining the Chairman and me in sponsoring this legislation.

Our bill will bring to an end a costly tax avoidance practice known as sale and leasebacks by government and tax-exempt entities. Through this practice, tax-exempt entities like cities and universities have, in effect, gone into the business of selling lucrative tax shelters to private investors.

How does this work? Because a city, for example, does not pay Federal income taxes it is unable to take advantage of the investment tax credit and depreciation deductions associated with its property. But a city can sell a building to a taxpayer, who can take advantage of the lucrative tax benefits, and then lease the building back to the municipal government.

We have witnessed in recent months an explosion in the use of sale and leaseback transactions by government and non-profit entities.

Bennington College wants to sell its entire campus to its alumni and lease it back;

The city of St. Louis has been exploring the possibility of selling its City Hall;

Baltimore has already sold its incinerator and a firehouse;

Oakland no longer owns its museum or coliseum;

Alexandria, Virginia has sold a municipal art studio and leased it back;

The Sunnyvalle, California Public Library is no longer owned by the public;

And even foreign governments have gotten into the act:

France has sold a satellite to American taxpayers and leased it back.

Who benefits?

The seller benefits because the sale price received is far greater than the amount that must be paid to leaseback the building in question.

The taxpayer-investor benefits from substantial tax write-offs purchased at bargain basement prices.

The middlemen—the lawyers and the brokers—receive substantial fees.

But, unfortunately, all of these gains come at the direct expense of the Federal government and of every American who pays taxes to support that government.

The sale and leaseback scheme is a tax gimmick, most of whose benefits go to the tax shelter investor. Only a small part of the revenues lost to the Federal treasury go to the cities, the colleges, and the tax-exempt organizations. If it is our intention to assist these organizations and units of government, then it makes no sense whatever to do so in a way that allows tax shelter investors to skim most of the money off the top.

I believe that we must do more to assist our ailing cities and states. We must do more for education at every level. We should continue and strengthen our commitment to transportation, housing programs and other worthwhile and legitimate Federal efforts to meet the needs of our state and local governments.

But I do not believe that we should be doing indirectly—through the tax code—the things which we are unwilling to do directly through the Congressional authorizations and appropriations process.

Our bill, "The Governmental Lease Financing Reform Act of 1983," reduces the benefits of depreciation for property that is leased by nontaxable entities. It tightens the Internal Revenue Code provisions which deny tax credits for property used by tax-exempt entities. It also extends that denial to foreign governments.

I know that some people are unhappy about this legislation. You can see that by looking around this room and looking at the witness list.

We are already feeling the pressure from the lawyers who stand to lose some legal fees.

We are hearing from the real estate developers.

We are hearing from the cities, states and colleges.

And we are even hearing from the foreign governments which are using the tax gimmick to subsidize their activities at the expense of the taxpayers of the United States.

On May 24, the Chairman and I had a colloquy on the Senate floor during which we announced our plans to introduce this bill. We also indicated that the bill would prohibit sale and leaseback transactions for property placed in service after May 23. The bill establishes that effective date.

Since May 24, the tax attorneys and financial consultants have been on notice that these tax scams would no longer be permitted. They were told that a transition rule would protect those who relied on existing law from any unfair financial hardship. That protection is included in this bill. It excludes projects subject to a binding contract as of May 23.

Mr. Chairman, I am reminded of an almost identical scheme contained in the 1981 tax bill—"safe harbor leasing." That provision permitted companies to buy and sell tax benefits.

What happened?

In 1981, for example, General Electric earned $1.6 billion in profit, but bought so many tax breaks that it actually received a $100 million tax refund.

And when the Finance Committee set out to repeal this tax gimmick, what happened? The special interests mobilized in order to keep a piece of the action. And despite your best efforts they picked away at the repeal legislation with so-called "transition rules." The steel industry; auto manufacturers; mass commuting vehicles; airplane manufacturers; and rural electric cooperatives; each received an exemption.

I am also reminded of Congressional efforts in the 96th Congress to reform the mortgage revenue bond program. Almost everyone agreed that the reforms were needed—so long as they didn't apply to them. And what we got was the reform, along with twelve pages of exceptions in the public law.

I believe that the effective date provision of this bill is fair. And I hope that we will be able to prevent exceptions from eating away at the thrust of the bill.

Mr. Chairman, last month I appeared before this Committee to testify on the subject of inefficient tax subsidies. At that time I urged the Committee to eliminate those tax subsidies which serve no substantial public purpose. I believe that the sale and leaseback tax scam is a subsidy that cannot be justified.

I urge the Committee to move forward with this legislation, and I stand ready to assist you in that effort.

Lease-A-Government

BY TYLER BRIDGES

At first glance, it was an obscure provision, one of the many pieces of graffiti written onto the Economic Recovery Tax Act of 1981. Later, many Senators and Representatives protested that they had never known it was part of the tax bill. But corporate financial managers, accountants, and tax lawyers were fully aware of the meaning of "safe-harbor leasing."

Overnight, a high-powered industry emerged to trade in tax credits and deductions. Companies that had "zeroed out" because their supply of loopholes exceeded their ability to use them, sold their "excess" tax benefits to companies still on the tax rolls in almost riskless paper shuffles.

Likened to a food stamp program for corporations, safe-harbor leasing allowed some highly profitable companies to pay no federal corporate income taxes in 1981. General Electric, an aggressive player, even collected a $100 million refund from past years' taxes. In only a few months of frenzied activity, safe-harbor leasing cost the federal Treasury at least $10 billion and perhaps as much as $15 billion in fore gone tax revenues.

It didn't take long, however, for safe-harbor leasing to become known throughout the U.S. — as a symbol of the unfairness of President Reagan's 1981 tax program. An outraged public forced Congress to halt the fast and furious "tax-benefit transfers" as part of the 1982 tax reform act.

But now, even as tax reformers and fiscal conservatives are still congratulating themselves for putting a tourniquet on Treasury's revenue hemorrhage from leasing, a close relative of safe-harbor leasing has appeared on the doorstep that could dwarf in scope its kissin' cousin.

This time it is not giant corporations that are selling the tax breaks. Instead, it is cities, counties, colleges, and even federal departments that want to get into the act, through unprecedented and imaginative uses of an older form of tax leasing, called "sale-leaseback" or "leveraged leasing."

Governmental bodies and tax-exempt - organizations selling tax breaks? How can it be? How can institutions that don't pay any taxes have any loopholes to vend?

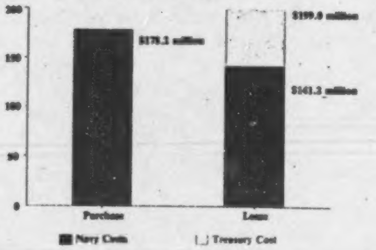
Strange as it may seem, however, tax-exempts *are* beginning to enter the tax-break marketplace. Bennington College, an expensive and exclusive liberal arts school in Vermont, for example, is arranging to transfer ownership of its campus buildings to alumni and lease them back. The city of Atlanta wants to sell and rent back its town hall, as does the city of Corpus Christi. Libraries, sewer systems, town art centers, and public school systems are all on or headed for the auction block.

Even federal agencies are itching to get a piece of the action. The Air Force wants to rent 120 CT-39 executive aircraft and 202 tanker transport bombers. The National Oceanic and Atmospheric Administration wants to sell and lease back its weather satellite system. The Department of Energy would like to "privatize" the controversial Clinch River Breeder Reactor.

"This thing is so big, it could amount to the biggest atom bomb in public finance in this century," says Representative J.J. Pickle (D-TX), Capitol Hill's leading critic of the burgeoning traffic in tax leasing by tax-exempt organizations.

The proponents of the new approach offer a different assessment. City managers, college presidents, the Secretary of the Navy, tax attorneys, and others view sale-leaseback as a savior, a cheap and innovative way to fund programs in a time of fiscal austerity, while avoiding costly and time-consuming federal regulations.

TAKX Cargo Ship
Purchase Vs. Lease Costs



Cargo ships leased

A look at the most celebrated government leasing deal, which involves the Navy, suggests that Rep. Pickle has the better of the argument.

Last fall, the Navy told Congress that it wanted to rent rather than purchase outright 13 TAKX cargo ships worth $2.3 billion for the Rapid Deployment Force, in a transaction involving General Dynamics, Waterman Steamship Corp., and Maersk Line Ltd.

Under the terms of the leveraged lease, the Navy would pay about $174 million a year to lease the ship — a total of $4.4 billion over the 25 year term of the lease. The Navy correctly points out that the "present value" of the rental payments, taking into account the time value of money, is only $1.8 billion (including the cost of buying the boats at the end of the lease term).

What the Navy doesn't properly take into account, however, is the net effect of the various tax breaks the deal will create. The staff of the Joint Committee on Taxation estimates the *total* cost to the government of leasing the ships (in "present value" terms) to be at least $2.6 billion — 12 percent more than an outright purchase.

Of course, there's no reason to expect the Navy to care about the higher overall cost to the federal government. Leasing would clearly be cheaper *for the Navy* — and would allow it to shift 30 percent of the cost of its ships from its budget to the federal Treasury's "tax expenditure" budget. At a time when Congress is beginning to take a closer look at defense spending, this is no mean trick.

Admiral Merrill Lynch

All sale-leaseback deals work the same way as the Navy's end-run around the budget — and share its drawbacks. Basically, a non-taxable agency or organization arranges to have a private group buy or construct some big-ticket item. The nominal owners, being taxpayers, get to claim a number of tax benefits, such as accelerated depreciation, interest deductions, and the investment tax credit.

The tax-exempt organization then signs a long-term lease at a price reflecting a pass-through of some share of the lessor's tax benefits. The paper owners — who now "own" the city's fire station, the university's basketball pavilion, the Defense Department's newest jet fighter, or whatever — are happy because their tax bills have been reduced at virtually no risk.

The agency or organization is happy because its budget looks smaller. But federal taxpayers will end up footing the bill for all of this — and paying much more than if they had simply given direct subsidies to the governments or tax-exempt groups.

"If this kind of thing continues, we're going to see E.F. Hutton own the Air Force, and Merrill Lynch rule the waves," says Rep. Pickle. "Can you imagine the average taxpayer's response? It's no wonder that citizens are losing confidence in the tax system."

Critics say the Treasury Department and the Office of Management and Budget should be concerned about the waste and increased deficits inherent in the federal leasing deals. So far, these agencies have not taken a position — perhaps because most of the added costs from leasing will be the problems of future administrations.

In the case of cities and tax-exempt groups, there are virtually no checks on irresponsibility, since the added costs of leasing are borne by federal taxpayers, not by the local organizations.

"What we have here is an open invitation for groups to back their trucks up to the federal Treasury and load up, no questions asked," says a congressional aide. "It's a back-door method of public finance."

Tax shelter of the 1980s

Only a few cities, counties, colleges, or other tax-exempt institutions have actually completed sale-leaseback deals. "There's more talk than action thus far," says Jacques Schlenger, a tax attorney with the Baltimore firm of Venable, Baetjer, & Howard. "But I think a lot of deals will be consummated this year." One real estate expert calls leveraged leasing the tax shelter of the 1980s.

City officials acknowledge that sale-leaseback financing is a tax shelter. But they say these deals are necessary because of cities' poor fiscal situation.

On top of the recession, federal

budget cuts have made the task of balancing city budgets a Houdini-like skill. Among the local programs the Reagan administration has slashed funding for are: Community Development Block Grants, the Historic Preservation Grant Fund, Urban Development Action Grants, and funds for constructing waste water treatment plants.

Cities and counties have also turned to sale-leaseback financing to obtain extra money to pay for the increasingly dilapidated infrastructure. One study reports that at least 50 percent of the nation's communities are unable to support any significant level of economic growth until major investments are made in rebuilding their deteriorating roads, sewers, bridges, and mass transit systems. The Environmental Protection Agency estimates that by the year 2000, more than 21,000 waste water treatment plants will be required at a cost of almost $100 billion.

"We face an infrastructure problem of crisis proportions," says Frank Shafroth, legislative counsel at the National League of Cities, which recommends that cities arrange sale-leaseback deals whenever possible.

Traditionally, cities have met their financial needs by issuing tax-exempt bonds. But increasingly skeptical voters have been more reluctant to approve bond issues, and interest rates cities pay on the tax-exempt bonds have risen to historically high real levels. "The market for municipal tax-exempt bonds has virtually dried up," says Joan Bennon, assistant executive director of the U.S. Conference of Mayors.

Many analysts have pointed out, however, that one of the main reasons why cities are being forced to pay such high interest rates on municipal bonds is the total lack of restraint they have shown in "renting" their tax exemptions to private businesses, which can then issue tax-exempt Industrial Development Bonds.

Tax-free bonds for private purposes now constitute well over half the tax-exempt market. Sale-leaseback deals, which typically involve the use of IDBs, would make the problems even worse.

Other cities, particularly those in California and Massachusetts because of state-wide ballot initiatives, have had difficulty issuing bonds because they are limited in how much they can go in debt. "We aren't willing to say that cities of Massachusetts should be flushed down the drain because the voters approved Proposition 2½ years ago," says Shafroth.

"Cities are in bad shape, and they need help," agrees Robert McIntyre, Director of Federal Tax Policy at Citizens for Tax Justice, a coalition of public interest and labor groups. "But sale-leaseback financing is a hopelessly inefficient way to help them.

"You don't have to understand the complex arithmetic to realize that leasing costs the federal government much more than handing out subsidies directly," says McIntyre. "Somehow or other the government must pay more, if only because of the middlemen involved — who will presumably want to be paid for their services."

"Cities say they need help," adds Rep. Pickle. "But what about the federal government? What shape is the federal government — and the economy — going to be in if we have even greater deficits?"

Innovative city managers

City officials respond that they are following the principles of the Reagan administration's New Federalism program. Because of federal budget cuts and the Administration's reluctance to help cities rebuild their infrastructure, "it seems like Reaganomics is saying this is the way cities should be run today," says John Flores, assistant city manager in Oakland, who sold the city's museum and convention center and then leased them back at a substantial budget savings.

"Local governments have been forced to be fairly inventive," says Tom Lewcock, city manager in Sunnyvale, Calif., who arranged to sell the city's public library to a limited partnership and then lease it back. Sunnyvale is using the money from the deal to construct a new public safety building.

"Washington has cut off the spigot," adds Howard Braitman, a CPA with Price Waterhouse in Philadelphia, who is consulting with cities to sell real estate that qualifies for the 25 percent historical preservation tax credit, an additional tax break. "Any city that doesn't take advantage of sale-leaseback financing is stupid," Braitman says.

Rep. Pickle is not waiting to see how widespread sale-leaseback financing becomes. He has already begun drafting legislation to "squeeze the juice out of sale-leaseback transactions."

Pickle wants to eliminate the tax breaks governments and tax-exempt organizations can offer. He would also require any agency considering a leveraged lease deal to factor in the federal tax expenditure in the overall project cost.

"I think Congress will crack down on sale-leaseback financing before it is unleashed on the American public," Pickle says. Sen. Howard Metzenbaum (D-OH) has indicated he will offer similar legislation.

Fat-cats and alcoholics

Michael Hooker, president of Bennington College, strongly opposes any congressional action to interfere with his scheme to lease and lease back much of Bennington's campus. Bennington is negotiating a "lease-leaseback" deal to avoid paying state property taxes and still take advantage of federal tax breaks.

"I find tax shelters appalling," says Hooker. "But if Congress is not going to eliminate all tax shelters," he says, "then it shouldn't cut off the leveraged lease shelter. It helps the nation's colleges and universities, which are in bad shape financially. Sale-leaseback is in the national interest, since it funds higher education.

"Besides," Hooker adds, "this is money Washington would never see. The money would otherwise be going into the pockets of fat-cat real estate operators and oil companies."

Responds Rep. Pickle: "That's like an alcoholic saying, 'If I don't drink that bottle of whiskey, then someone else will.'"

Adds CTJ's McIntyre, "Obviously moral philosophy, not to mention economics, is not on Bennington's curriculum."

About 10 other colleges and universities have already completed leveraged lease deals. Hooker reports that from the publicity the Bennington deal has gotten, he has received over 25 calls from other schools, including a couple of prominent Ivy League universities.

"The leveraged lease industry is still in its infancy, so it's important to act now," says Pickle. "The genie's not out of the bottle yet.

"Before long, we'll be up against an entrenched special interest group. A 'National Tax-Exempt Leasing Association' will have been created, and tax lawyers and accountants will be traveling around the country promoting leveraged lease deals." ■

The CHAIRMAN. Our next witness, who appears here at least on a weekly basis, is Buck Chapoton, the undaunted Assistant Secretary for Tax Policy.

STATEMENT OF JOHN E. CHAPOTON, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, D.C.

Mr. CHAPOTON. Thank you, Mr. Chairman. I am happy to be here to present the administration's views on this matter before you, envisioned on this side in S. 1564.

We generally support the provisions of this bill. We are concerned that there has been a sharp increase in the volume of leasing between taxable entities as lessors and tax-exempts as lessees. So we think some action must be taken by the Congress to deal with the problem.

As Senator Metzenbaum stated, there have been a number of very celebrated transactions—the Atlanta City Hall is certainly one of them, Bennington College is another, and in recent weeks there have been several more.

S. 1564 is intended to deal with this problem by reducing significantly the tax incentives associated with the ownership of property that is leased to a tax-exempt entity, including government entities and in certain cases foreign users. Generally this is accomplished by a lengthening of the period over which the owner of the property may claim cost-recovery deductions.

We strongly support the provisions of S. 1564 that relate to the two areas that we think present the most concern: The first is the sale leaseback by a tax-exempt entity of property that it has owned and used for a substantial period of time; and the second case is the lease to a tax-exempt entity of property that is financed with obligations the interest on which is exempt from income tax. That is usually industrial development bonds.

Generally speaking, the tax incentives available for investment in depreciable property are intended to stimulate new investment. These tax benefits will flow through to the lessee in the case of a lease in the form of reduced rent; but to permit tax-exempt lessees the right to enjoy these benefits in the case and leaseback of their existing assets will result in an unintended tax windfall to these entities. It would enable them to refinance their existing assets through lease transactions and thereby get a Federal grant in the form of tax benefits, even though the transaction does not result in any new investment by the tax-exempt entities. We are concerned that, if left unchecked, this arrangement could indeed result in unanticipated revenue losses of several billions of dollars annually.

Unintended tax benefits have also been secured in leasing transactions where the acquisition or construction of the property has been financed with tax-exempt bonds. We consider this a classic case of double-dipping. Not only does the lessee receive the benefits of cost recovery deductions through lower rentals, but he also receives the benefit of rent reduction attributable to low-interest tax-exempt financing.

Dealing specifically with the bill in the case of real property, the bill applies the more stringent depreciation period to real property if more than 50 percent of the property is occupied by a tax-exempt entity, but only if one of four conditions are met:

First, the property is financed with tax-exempt obligations and the lessee participated in the financing;

Second, the property is a sale and leaseback;

Third, the property is leased under an arrangement that contains a fixed price, purchase, or sale option to the lessee; and

Fourth, that the property is used under a lease that has a term exceeding 10 years. There is a de minimus exception that would not apply under the bill if the property were leased for a term of less than 3 years.

We agree with this general approach. As mentioned, we think one of the cases that presents the greatest potential for abuse is the sale leaseback. That is covered. A second case is the property financed with tax-exempt obligations, and that's covered.

We would expand that second category as applied to real estate, as provided in the bill, and we would say that the limitation should apply whether or not the lessee participates in the tax-exempt financing. In other words, we would say, if there is tax-exempt financing, that alone is sufficient to deny fast depreciation if the property is leased to a tax-exempt entity.

We also support the provision of the bill with respect to real estate that would apply the limitation where the lease contains a fixed-price purchase or sale option at the end of the lease. We think it is reasonable in this area to set forth strict, objective standards that must be satisfied in order for the transaction to obtain favorable tax treatment. For this reason, we would recommend expanding the coverage of this bill to say that a proscribed lease not only is a lease where there is a fixed-price purchase option but it is also a lease that extends for more than 80 percent of the property's useful life.

The 80 percent of useful life and the fixed-price purchase option are criteria contained in IRS ruling guideline. If they exist, the IRS is not willing to rule that the transaction is a lease. We think these clear objective standards could be codified in this law to say what will not be considered a lease, and thus will not receive accelerated depreciation.

We have no objection and do support an exception for short-term leases of real estate—that is, 3 years in this bill. We do recommend, however, a reduction in the threshold occupancy rate to something less than 50 percent. As I stated, the bill provides that it does not apply unless the tax-exempt lessee occupies more than 50 percent of the building. We think that level is too high and would still present a significant potential for abuse. We suggest a de minimus level of something like 10 percent.

In the case of personal property, this bill, subject to an exception for short-term leases and short-lived property, would apply to all personal property that is leased to a tax-exempt entity.

In this case we think that the bill is overly broad. We think that the rules I have just stated with respect to real property should also apply to leases of personal property of the tax-exempts; that is, that the proscription would apply only if the property is (a) subject to a sale leaseback, (b) is financed with tax-exempt obligations, or (c) is subject to a lease which contains either a fixed-price purchase option or a lease term that exceeds 80 percent of the property's useful life.

We are concerned about imposing the restrictions in other cases, since that could cover cases that are clearly not motivated by tax considerations and would cause, we are concerned, undue complexity and administrative problems. Also, if we limit the coverage of the bill as we have suggested, to the three cases I have mentioned, it would eliminate any need for an exception for short-lived property.

We would support a de minimus exception for short leases. The bill does not apply if the lease does not exceed 1 year or 30 percent of the property's present class life, but in no case in excess of 3 years. We think that is a good approach. For simplicity, you might just say it doesn't apply if the lease is shorter than 1 year.

As I mentioned, the approach of the bill if a lease comes within the prohibited category is to lengthen the life, the depreciable life, of the property. We agree with the lives selected in the bill. The purpose here is to attempt to come close to economic depreciation, and, while it is difficult to set forth what would be economic depreciation, we think the approximation sought in the bill on both personal property and real property is adequate.

In the case of leasing to the Federal Government, different considerations apply. We have no objection to the broad application of the proposed tax rules as contained in this bill to leases to the Federal Government, and subject to appropriate short-term lease rules or other de minimus exceptions. We think the bill should apply to all property leased to the Federal Government whether or not the property would otherwise be subject to the restrictions of property leased to other tax-exempt entities. That is a very broad rule applied to leases to the Federal Government.

We would note, however, that considerations relating to the Federal Government leasing are different than in the case of leases to tax-exempts and other State and local governments.

In the case of a lease to the Federal Government, there is no real budget impact, because we are on both sides of the transaction, if you will, provided the lease is properly accounted for in the budget process. Treasury has worked with the Office of Management and Budget to develop guidelines for evaluating leases where the Federal Government is the user of the property. The purpose of these guidelines is to determine whether it is cheaper for the Government to buy or lease a particular item or property and, if it's leased, to determine what the overall budget will be. These guidelines are going to be needed whether or not the tax reduction in this bill is adopted, because there will still be some cases where the Government will want to be a lessee.

We do support, Mr. Chairman, the rather stringent transitional rules in the bill. We do, however, think that no more stringent transitional rules should apply to leases to the Government than do apply to other taxpayers, and we also think that the May 23 date, which is the grandfather date under the bill—contracts entered into before that date would be grandfathered—that that should apply, that the transactions with the Government that were approved prior to that date by Congress should be under the grandfather.

I will conclude my remarks, and I will be happy to answer any questions.

[The prepared statement of Hon. John E. Chapoton follows:]

For Release Upon Delivery
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July 19, 1983

STATEMENT OF
THE HONORABLE JOHN E. CHAPOTON
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Committee:

I am pleased to appear before you today to discuss S. 1564, the Governmental Lease Financing Reform Act of 1983, which would deny certain tax incentives for property used by governments and other tax-exempt entities.

The Treasury Department generally supports the bill. Certain leasing transactions involving tax-exempt entities permit these entities to obtain unintended tax benefits and may lead to tremendous unanticipated Federal revenue losses. We believe corrective measures should be enacted along the lines suggested by the bill.

Background

There has been a sharp increase recently in the volume of leasing between taxable entities, as lessors, and tax-exempt entities, as lessees. Some of the more celebrated transactions include the sale and leaseback of the city hall building in

Atlanta and the sale and leaseback by Bennington College of its classrooms and dormitories to its alumni. The pace of such transactions is accelerating rapidly, and they have been the subject of extensive publicity in both the financial and general circulation media.

The lease transactions that have received the most publicity involve the sale by a tax-exempt entity of a depreciable asset that it owns (usually a building) to a taxable investor, followed by a long-term lease of the property back to the tax-exempt entity. As lessee, the tax-exempt entity retains essentially the same use of the property as it had before the sale and is obligated to make a series of periodic rental payments to the lessor. As the owner of the property, the lessor is entitled to any depreciation or cost recovery deductions and tax credits associated with the property. A portion of the tax benefits claimed by the lessor flow through to the tax-exempt entity in the form of reduced rents. In some cases, the lessor may be able to finance its acquisition of the property with tax-exempt industrial development bonds ("IDBs").

Whether an agreement that, in form, is a lease is considered for tax purposes to be a lease, a conditional sale, or other financing agreement is a question of fact to be determined from all the surrounding circumstances. The tax status of such an agreement is important because ownership of the property for tax purposes determines the party entitled to claim the cost recovery deductions and investment credits (if any) associated with the property.

Cost Recovery and Depreciation Deductions. If an agreement is treated as a lease for tax purposes, the lessor is considered the owner of the property. As such, the lessor is required to include in its taxable income any rental income received and is also generally entitled to recover its cost of the property through depreciation deductions under the Accelerated Cost Recovery System (ACRS) enacted in the Economic Recovery Tax Act of 1981 (ERTA). Under ACRS, cost recovery deductions are taken over 3 or 5 years for most personal property and over 10 or 15 years for public utility property and depreciable real property.

The ACRS rules generally apply only to property that is acquired after 1980. If the property was owned either by the lessor or the lessee prior to 1981, the lessor's depreciation deductions are limited to those allowable under the law in effect prior to ERTA. In that case, the deductions to the lessor must be spread over the useful life of the property, and the method of depreciation (*i.e.*, straight line or accelerated) will vary depending upon the nature of the property and whether the original use of the property commenced with the lessor. Under the law prior to ERTA, the lessor's depreciation deductions for buildings and other depreciable real property generally must be computed using the straight-line method if the lessor is not the original user of the property. Nevertheless, even under the law prior to ERTA, there are many cases in which the lessor's depreciation deductions are more rapid than the economic depreciation of the property.

In general, whether a lessee is a taxable or a tax-exempt entity is irrelevant in determining the timing and amount of cost recovery deductions allowable to the lessor. However, special rules apply to limit the lessor's depreciation deductions where the property subject to the lease is used predominantly outside the United States. For personal property used outside the U.S., cost recovery deductions are generally limited to a rate that is twice the straight-line rate over the present class life of the property under the ADR system.

Investment Tax Credit. The tax status of the lessee is important in determining the eligibility of leased property for the investment tax credit. A lessor of property that qualifies for the regular investment credit generally is entitled to a tax credit equal to 10 percent (6 percent in the case of short-lived property) of his investment.

Investments in real property are usually not eligible for the investment credit, but a special tax credit is allowed for certain "qualified rehabilitation expenditures." The tax credit for qualified rehabilitation expenditures (which are generally capital expenditures incurred in the rehabilitation of an existing structure) varies from 15 percent to 25 percent of the total expenditures, depending on the age of the rehabilitated structure and whether the structure qualifies as a "certified historic structure." The special credit for qualified rehabilitation expenditures is available for buildings leased to tax-exempt entities.

In general, property used by an organization that is exempt from tax or a governmental unit or agency, including the United States and any State or political subdivision thereof, does not qualify for an investment credit (other than the special credit for qualified rehabilitation expenditures). In determining whether property is considered "used" by a tax-exempt entity and is thus not eligible for the regular investment credit, the Treasury regulations state that property is used by a tax-exempt entity if the property is owned by or leased to a tax-exempt entity. The restriction placed on property leased to a tax-exempt entity does not, by regulation, apply to short-term or casual leases (generally leases of less than one year's duration).

Service Contracts. While the regular investment credit is not available for property leased to a tax-exempt entity, the investment credit limitation does not apply to property that is used by the owner in providing services for a tax-exempt entity under a service contract. Whether an agreement is a service contract or a lease is an inherently factual determination. Under a lease agreement the lessor generally transfers possession and control of the property to the lessee for a stated term, and the lessee is responsible for the day-to-day operation of the property. In contrast, under a service agreement, the party who receives the services from the property may be able to direct when and where the property is to be used; but control, possession, and day-to-day operation of the property remain with the supplier of the services. There are a handful of cases and IRS rulings that apply these guidelines to different factual circumstances.

Tax-Exempt Financing. In addition to the investment credits and ACRS deductions associated with the leased property, tax-exempt obligations frequently are issued to finance the acquisition or construction of the property. Section 103(a) of the Code generally exempts from Federal taxation interest paid on obligations of a State or local government. Section 103(b) of the Code restricts the tax exemption for IDBs to obligations whose proceeds are used for certain specified purposes.

S. 1564
The Governmental Lease Financing Reform Act of 1983

In general, S. 1564 is intended to reduce significantly the tax incentives associated with the ownership of property that is used by governmental and other entities that are exempt from Federal income taxes. This is accomplished generally by lengthening the period over which the owner of the property may claim cost recovery deductions with respect to the property and by tightening the criteria that are used in distinguishing a lease from a service contract. The bill also would eliminate many of the tax benefits associated with certain property used by foreign persons.

Specifically, S. 1564 would provide that, except in the case of a short-term lease, the cost recovery deductions for personal property used by a tax-exempt entity must be computed using the straight-line method over the greater of (i) the present class life of the property under the ADR system, or (ii) a period equal to 125 percent of the term of the lease. The cutback in the cost recovery deductions for personal property would not apply where the term of the lease does not exceed the greater of 1 year or 30 percent of the property's present class life (but not to exceed 3 years). In addition, the bill would not apply to personal property with a present class life of 6 years or less, but only if the lease term to which the property is subject is 75 percent or less of the property's class life.

In the case of property in the 15-year real property ACRS class, the cost recovery period would be extended to the greater of (i) 40 years or (ii) a period equal to 125 percent of the term of the lease, but only if 50 percent of the property is used by the tax-exempt entity and either: (a) the property was financed in whole or in part with tax-exempt obligations and the tax-exempt entity participated in the financing; (b) the tax-exempt lessee has an option to acquire the property for a fixed price or the lessor has the right to sell the property to the tax-exempt lessee for a fixed price; (c) the tax-exempt entity sold (or leased) the property and then leased it back; or (d) the property is used pursuant to a lease with a term that is greater than 10 years. The bill would not apply to a lease of real property if the lease term were less than 3 years (or less than 1 year in the case of a building that is eligible for the special credit for qualified rehabilitation expenditures). Property that is not recovery property under the ACRS rules would be treated as recovery property for purposes of these restrictions.

Further, the bill would eliminate the special credit for qualified rehabilitation expenditures to the extent that the expenditures are allocable to the portion of the building that would be subject to the reduced cost recovery deductions.

In addition to Federal, State, and local governmental units and other tax-exempt organizations, the bill would include foreign persons within the scope of the term "tax-exempt entity," but only with respect to property 80 percent or more of the income derived from the use of which is not subject to tax in the U.S. In such a case, the cost recovery deductions with respect to such property would be limited in the same manner as described above in connection with other tax-exempt entities. The bill would also deny an investment credit on such property.

The bill would place further limits on the types of agreements that will qualify under current law as service contracts. The determination of whether an agreement is a lease or service contract would be based on all the facts and circumstances, including whether (i) the tax-exempt user controls or has physical possession of the property, or has a significant possessory or economic interest in the property; or

(ii) the service provider bears any substantial risk of loss from nonperformance or concurrently uses the property to provide services to taxable entities.

The provisions of the bill generally would apply to property placed in service after May 23, 1983, except that the bill would not apply to property placed in service after that date if, pursuant to one or more binding written contracts in existence on May 23, 1983, (i) the taxpayer is under an obligation to acquire, construct, or rehabilitate the property, and (ii) the tax-exempt entity is obligated to use such property. This special transitional rule for property subject to a binding contract on May 23, 1983, would apply to property used by the United States only if such property is placed in service before January 1, 1984.

Finally, the amendments made by the bill would not apply to a "mass commuting vehicle" (as defined in section 103(b)(9) of the Code) which is described in section 208(d)(5) of the Tax Equity and Fiscal Responsibility Act of 1982.

Discussion

The Treasury Department strongly supports the provisions of S. 1564 that relate to the cases that present the greatest potential for abuse, namely, (i) the sale and leaseback by a tax-exempt entity of property that it has owned and used for a significant period of time, and (ii) the lease to a tax-exempt entity of property that is financed with obligations the interest on which is exempt from tax.

Generally speaking, the tax incentives available for investment in depreciable property are intended to stimulate new investment. In a typical long-term lease transaction, these tax incentives will flow through to the lessee in the form of reduced rents. To permit tax-exempt lessees the right to enjoy these tax benefits in the case of a sale and leaseback of their existing assets will result in an unintended tax windfall to these entities. It would enable them to refinance their existing assets through lease transactions and thereby allow them to receive government grants in the form of tax benefits, even though the lease transactions do not result in any new investment by the tax-exempt entities. We are concerned that if this practice is left unchecked, the unanticipated revenue loss could be billions of dollars annually.

Unintended tax benefits have also been secured in leasing transactions where the acquisition or construction of the property has been financed with tax-exempt obligations. These cases of "double-dipping" are particularly troublesome. Not only does the lessee receive the benefits of cost recovery deductions in the form of reduced rentals, it also receives the added benefit of rent reductions attributable to low-interest, tax-exempt financing.

Scope of the Bill

Real Property. In general, the bill would apply to real property more than 50 percent of which is occupied by a tax-exempt entity, but only if either (i) the property is financed with tax-exempt obligations and the lessee participated in the financing; (ii) the property is sold by the tax-exempt entity and leased back; (iii) the property is used under a lease that contains a fixed-price purchase or sale option; or (iv) the property is used under a lease with a term that exceeds 10 years. The bill would not apply if the lease term were less than 3 years (or 1 year in the case of a building that qualifies for the special credit for qualified rehabilitation expenditures).

We agree with the general approach of this portion of the bill. As mentioned above, the cases that present the greatest potential for abuse in the area of leasing by tax-exempts are (i) sale-leaseback transactions and (ii) leases of property that is financed with tax-exempt obligations. However, for the reasons outlined above, we think this latter category should be expanded to include any property that is financed with tax-exempt obligations, whether or not the lessee participated in the financing.

We support the provision of the bill that would apply the restrictions to property that is used under a lease containing a fixed-price purchase or sale option. We think it is reasonable in this area to set forth strict, objective standards that must be satisfied in order for the transaction to obtain favorable tax treatment. In furtherance of this approach, we recommend expanding the coverage of the bill to include property that is leased for a term that exceeds 80 percent of the property's useful life. These objective standards are currently contained in the guidelines used by the IRS for issuing advance determinations on the status of transactions as leases.

We recommend an elimination of the catchall provision that would deny benefits for all real property leased to a tax-exempt entity for a term that exceeds 10 years. We suggested including this provision in our June 8 testimony before the House Ways and Means Committee on H.R. 3110, the Governmental Leasing Tax Act of 1983. However, upon reflection, we now do not believe that such a sweeping provision should be included as part of the bill. The practical effect in any case in which the provisions of the bill apply is that a tax-exempt entity would pay a higher rent than taxable lessees because the cost recovery deductions of the lessor would be reduced, even though there is no fixed price purchase or sale option and the lease term is much shorter than the property's useful life. We believe that the objective standards suggested above are adequate to ensure that the transaction is a lease. The 10-year limitation of the present bill would impose an unnecessarily rigid limitation on leases by tax-exempt entities, and we therefore suggest it be eliminated.

For similar reasons we have no objection to the exception in the bill for short-term leases. However, we recommend a reduction in the threshold occupancy rate to something substantially less than 50 percent, say, for example, 10 percent. We think a de minimis exception is necessary in order to prevent undue complexity and administrative problems, but the 50 percent level set out in the bill would still present a significant potential for abuse.

Personal Property. Subject to an exception for short-term leases and short-lived property, the bill would apply to all personal property that is leased to a tax-exempt entity. We think the coverage of the bill in this respect is overly broad. As in the case of leased real property, we believe that tax benefits with respect to personal property leased to tax-exempt entities should be denied if (i) the property is subject to a sale-leaseback; (ii) the property is financed with tax-exempt obligations; or (iii) the property is subject to a lease that contains a fixed-price purchase or sale option or that extends for a term that exceeds 80 percent of the property's useful life. However, we do not support imposing the restrictions in other cases, since broader application of the restrictions would affect leases of newly acquired property that are clearly not motivated by tax considerations and would cause undue complexity and administrative problems. Limiting the coverage of the bill as we suggest would eliminate any need for an exception for short-lived property.

Finally, we support the exception the bill creates for leases with terms that do not exceed the greater of 1 year or 30 percent of the property's present class life (but not in excess of 3 years). Alternatively, the Committee might consider having a 1-year short-term lease exception in the interest of simplicity.

Proposed Limitations

Cost Recovery Deductions. The bill generally provides that property subject to the restrictions may not be depreciated at a rate that exceeds the greater of straight-line depreciation over (i) 125 percent of the lease term, (ii) the present class life of the property in the case of personal property, or (iii) 40 years in the case of real property. We support this provision of the bill. To eliminate fully any tax advantage for tax-exempt entities to engage in a proscribed lease transaction, the lessor's depreciation should be limited to a rate no faster than the economic rate of depreciation. We believe that the depreciation schedule in the bill represents an adequate approximation of economic depreciation for a broad range of property.

Qualified Rehabilitation Expenditures. We agree with the general approach of the bill in denying the special credit for qualified rehabilitation expenditures for property that would be subject to the stricter rules for depreciation.

Leasing by the Federal Government

The restrictions on leasing of property to governments and other tax-exempt organizations proposed by S. 1564 would apply when the Federal government is the lessee. We have no objection to this broad application of the proposed tax rules, and recommend that, subject to a short-term lease or other *de minimis* exception, the bill apply to all property leased to the Federal government, whether or not the property would otherwise be subject to the restrictions on property leased to other tax-exempt entities. However, we wish to note that the considerations relating to Federal government leasing are different from those presented in the case of leasing by State and local governments and tax-exempt organizations.

The allowance of tax incentives on assets leased to the Federal government, *per se*, has no real budget impact, provided the lease is properly accounted for in the budget process. If Congress authorizes the purchase of property by a Federal agency, the full cost of that service is reflected in the outlay side of the budget. Assuming that Congress approves of the purpose served by that same property when it is leased from a private lessor, then the cost will be borne on both sides of the budget: on the outlay side to the extent of lease rentals paid to the lessor; on the revenue side to the extent that tax incentives are used by the lessor. The "problem" of Federal government leasing, therefore, is not its effect on the budget. Thus, the objective of the bill should be to ensure that full accounting for costs takes place and that the choice between the government's purchase and lease is based on the lower cost alternative.

The effect of restricting the terms of Federal government leases to economic depreciation and denying the investment tax credit for property used in performing service contracts therefore will have no real effect on the deficit. Nevertheless, the resulting higher rentals will have the salutary effect of more accurately displaying the cost of government leases of equipment and buildings than is presently the case.

Treasury is now working with the Office of Management and Budget to develop guidelines for evaluating leases where the Federal government is the user of the property. The objective of these guidelines is to provide a procedure that will enable agency procurement officials and OMB examiners to determine, in particular instances, whether it is cheaper for the government to buy or lease a particular item of property, and, if it is leased, what the overall budget effect will be. Obviously, these guidelines can be tailored to include any changes in the tax treatment of lessors. The guidelines will be needed whether or not private sector tax incentives are consequential, for leasing may afford the Federal government cost reductions without regard to its tax treatment.

Lease vs. Service Contract

Any reduction in tax incentives for property that is used by a tax-exempt entity will place a great deal of pressure on the distinction between leases and service contracts. Accordingly, S. 1564 attempts to prevent the use of service contracts to avoid the limitations on cost recovery deductions and investment credits applicable to leased property. We support this effort and agree with the approach of the bill. The present criteria used by the courts and the IRS in categorizing agreements as service contracts are too liberal and should be tightened.

Transitional Rules

In general, the provisions of the bill would apply to property placed in service after May 23, 1983, unless on that date the taxpayer was under a binding contract to acquire the property and the tax-exempt entity was under a binding contract to use the property. In the case of property leased to the Federal government, the transitional rule would apply only if the property is placed in service by January 1, 1984.

We agree that a strict set of transitional rules is desirable, particularly where the participants in the lease transactions are taking advantage of an unintended benefit. However, we also believe that the transitional rules that are included in the bill for property leased to other tax-exempt organizations should be applied to property that is leased to the Federal government. Also, we think the bill should grandfather any lease transaction for which Congressional approval was given by May 23, 1983, providing that a binding contract with respect to such a transaction is concluded by September 30, 1983.

Foreign Lessees

We believe that additional policy considerations should be taken into account in the context of international transactions. We are concerned in particular about the potential impact of the bill on U.S. exports and believe that special care must be taken to protect the international competitiveness of the United States.

Under present law, Congress has differentiated between property used predominantly in the United States, which receives full ACRS benefits, and property used predominantly outside the United States. The investment tax credit generally is not allowed with respect to such foreign use property. Cost recovery allowances for foreign use property are calculated using longer class lives, but accelerated depreciation methods are allowed with respect to the longer lives. Certain limited categories of equipment used in international transportation and international communications are excepted from the limitations associated with foreign use property.

The bill would increase the limitations of present law by extending the recovery period for certain kinds of property and requiring straight-line depreciation for property covered by the bill, if it is used by a foreign person and 80 percent or more of the income derived from the use of the property is not subject to U.S. tax. The bill would override the exceptions provided by present law to the foreign use property limitations if the property is used by a foreign person.

In the international area, the bill would have two principal effects. First, the bill would deny the investment tax credit and provide less rapid depreciation for property that would otherwise qualify under one of the foreign use property exceptions of present law (*e.g.*, international transportation or communications equipment) if it is used by a foreign person not subject to more than a *de minimis* amount of U.S. tax. Second, the additional limitations in the bill on cost recovery allowances for property used by foreign persons would increase the cost of lease-financed exports of the remaining kinds of property covered by the bill. U.S. exports could be adversely affected by these changes from present law.

We have no objection to limiting depreciation to an approximation of economic depreciation in certain cases where property is used outside the United States. We are concerned, however, that the application of these limitations to U.S.-produced property could significantly affect U.S. exports. Thus, we recommend that U.S.-produced property used by a foreign person be subject to the bill's limitations in the same circumstances as applied to a domestic tax-exempt entity, namely, if (i) existing property is subject to a sale-leaseback, (ii) property is financed with U.S. tax-exempt obligations, or (iii) property is subject to a lease that contains a fixed-price purchase or sale option or that extends for a term that exceeds 80 percent of the property's useful life.

We generally support the approach of the bill as it would apply to foreign-produced property, subject to the following modification. We recommend eliminating the exceptions in the bill for certain kinds of property and leases where there is a lease of foreign-produced property. We suggest, therefore, that the bill's limitations on cost recovery and investment tax credit be applied in any case where a U.S. person leases foreign-produced property to a foreign person not subject to more than a *de minimis* amount of U.S. tax. In this circumstance the transfer of tax benefits is clearly unjustified by tax or economic policy.

This concludes my remarks. Let me say that we would be pleased to work with the Committee on this bill. I would be happy to respond to any questions that you may have at this time.

The CHAIRMAN. I think generally there has been some indication since you testified at the House that the administration has changed its position. In fact, I think there are some who would say you have changed substantially.

What are the revenue consequences to Treasury, the reported changes since you first testified, since you are now testifying?

Mr. CHAPOTON. There is really one area where we have changed from our House testimony, Mr. Chairman. That area is leases of new property to tax-exempt entities; that is, leases of property that is not leaseback, not property that has been used by a tax-exempt entity before.

On the House side we said the bill should restrict all such property; but, on further consideration, we decided that we ought to apply that rule with respect to new property, only where the property is financed with tax-exempt obligations or where the transaction is not a true lease in the sense that it either has a fixed-price purchase option at the end or it's more than 80 percent of the lease term.

The CHAIRMAN. What are the revenue impacts?

Mr. CHAPOTON. Over the 5-year period, the approach in the House bill would have picked up $6 billion—there would be a $1 billion difference. The approach in the House bill would pick up $5 billion.

Now, another item in the House bill that we said we wanted to take more time to consider was leases to foreign entities. The House bill and the bill before this committee are quite strict on leases to foreign users. We have now considered this question further, as we requested more time in the House side. We think there is no policy to encourage more modern plant and equipment by allowing depreciation on property used outside of the United States. In other words, we are not trying to make Air France more efficient. But we also think that we must recognize the impact on exports if we reduce the depreciation provisions for property manufactured in the United States and leased abroad.

Therefore, we are not proposing any change with respect to property manufactured in the United States and leased abroad.

The CHAIRMAN. Let me now recognize Senator Bentsen.

Senator BENTSEN. Thank you very much, Mr. Chairman.

Mr. Secretary, I think you are hitting on the point that is of some concern to me.

It is obvious from what we have heard from Senator Metzenbaum and what has been presented by our chairman here that there has been substantial abuse of the utilization of nontaxable public entities for this purpose; but I have some concern about what happens to companies leasing equipment abroad and how that affects jobs finally here in the manufacturing of those pieces of equipment.

Do you have any kind of an estimate as to what these changes would do to commercial transactions of equipment being leased abroad and the possible frustration of those deals or the thwarting of those deals, and in turn, then, its loss in revenue to the Treasury?

Mr. CHAPOTON. We have discussed with USTR and in our own shop the possible impact on exports, which I think is obviously the point you are making. We can't quantify it or we haven't been able to yet, but it would be significant. A significant amount of property manufactured in the United States and used abroad is financed through U.S. lessors.

As I stated earlier, the policy behind giving accelerated depreciation deductions for equipment is to make that equipment more efficient and to upgrade and increase productivity in America. That policy does not apply when you are talking about property used abroad; but we cannot ignore the trade considerations.

Senator BENTSEN. But you made your point about, for example, Air France. They are supposed to buy the Air Bus instead of buying our planes; and I can think of many other end products that really would not harm manufacturing in this country or competition in this country in their end use abroad, particularly service products.

Mr. CHAPOTON. Yes, sir. It simply provides a benefit to exports of goods and services produced in this country. The same consideration would not apply to goods produced by a U.S. manufacturer abroad.

Senator BENTSEN. Well, do I understand, then, the administration is holding somewhat in abeyance their views on that part of the bill as they further study it?

Mr. CHAPOTON. No. We did that on the House side. We have now concluded that existing law should continue to apply.

Senator BENTSEN. You should stay with ACRS instead of ADR?

Mr. CHAPOTON. Yes; with minor exceptions that usually would not apply. For example, a sale leaseback of property used abroad would be no good. Also, if it is financed with tax-exempt obligations, which would not usually be the case, it would not be good. And we would further say that it must really be a lease, that it would meet the IRS guidelines as a lease rather than a sale abroad.

Senator BENTSEN. I would be concerned that actually we would be harming ourselves in this situation on some of the leasing of products abroad and would severely hamper exports.

Mr. CHAPOTON. We are concerned about that, too, Senator.

Senator BENTSEN. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Long?

Senator LONG. Mr. Secretary, I have a lot to learn in this area. I think you can help me with some of it.

I am concerned that our single-entry bookkeeping system is preventing us from doing some things that I think would be in the national interest. I could best illustrate that by pointing out that a single-entry bookkeeping system is not adapted at all to the management of inventory. Isn't that correct?

Mr. CHAPOTON. That is correct.

Senator LONG. In other words, just to explain it for the benefit of the audience, insofar as you have inventory on hand under a single-entry bookkeeping system, once you pay for it, it would appear that the money is gone. For example, if you have a bank, you have to have a vault, you have to have a security force, they have to have weapons to defend the bank if need be, and an alarm system, and so forth, and under a double-entry bookkeeping system you put the building on the books as an asset, you put all the weapons, the vaults, and the other properties on the books as assets, and on the liabilities side you put the money that you borrowed in order to acquire those assets. But the books balance in that the assets offset the liabilities, so it does not reduce your net worth.

But under a single-entry bookkeeping system, if you had $1 million worth of assets, all that would be listed as though it was gone and never to be seen again, when as a practical matter it is still sitting there as an asset. A single-entry system simply doesn't put assets on one side of the ledger and liabilities on the other.

That being the case, when the Government buys a cargo ship, for example, it looks as though we lost money the day we paid for it.

Mr. CHAPOTON. That's right. We are on a cash-basis accounting. The U.S. Government does account for its capital.

Senator LONG. Business people wouldn't consider doing business that way, because they feel that a double-entry system makes far more sense, because you put the asset on one side and the liability on the other side, and you have a net worth accounting at the bottom.

The fact that we have a single-entry system places a very grave burden on this Nation as we try to build up our defenses, because if you purchase an airplane that might be good for 20 years, barring some undue accident or its being shot down in warfare or something like that, that transaction goes down on the books just as though the money is gone the day you paid for it. Isn't that about the size of it?

Mr. CHAPOTON. That's correct.

Senator LONG. If someone else buys a cargo ship or an airplane and you lease it from him, at least you tend to get some offset against the burden of a single-entry bookkeeping system, because that person had a double-entry system. His books don't reflect that he's lost his money, and all you are paying is in effect the rent.

Mr. CHAPOTON. That's right.

Senator LONG. Now, in the long run I would assume it costs more money to do business that way; but in the short run it takes a very heavy burden off of what appears to be a very large Federal loss.

Now, we do that with regard to office buildings under an act passed by Congress, don't we? Somebody can build an office building for the Government under a lease-purchase arrangement; we have the right to buy it anytime we want to; meanwhile, we lease it from him. We have been doing that for many, many years.

Mr. CHAPOTON. That often happens. Yes, sir.

Senator LONG. The effect of is, for budgetary purposes, to permit us to acquire a lot of needed office space that otherwise we couldn't very well have acquired because it would make our budget look so bad.

Now, are you concerned about that part of the problem?

Mr. CHAPOTON. Senator, we have addressed that part of the problem, and what you are suggesting is that in some cases it is more responsible financially to lease than to buy, and clearly that is correct.

I think the point of this bill is, in doing so, we ought to account for the full annual cost of the lease transaction and not show a reduced cost by the reason that on someone else's books the taxes are being reduced; but we don't show this tax loss on ours. The idea is that the tax benefits pay part of the rentals to the lessor, and—the

Government, whoever the Government agency should be accounting for it. There would still be many instances when it is more advantageous to lease, even without the tax benefits.

Senator LONG. My concern is with a result under which one would think that we can't defend the country because it would look as though the cost is prohibitive, on the theory that the day we buy a long-term asset, that a single-entry bookkeeping system makes it look like you've lost your money. If you could spread it over a period of time, the way any business would do, your books wouldn't appear one fraction that bad.

Now, over a period of time, obviously, you would probably save money by not leasing, by simply buying directly. But in the short run it could well mean that you could not adequately defend the country.

Mr. CHAPOTON. And it may more correctly spread the cost of the equipment or the asset over the life of the asset. That is correct. And as I say, leasing will go on even if this legislation is passed.

Senator LONG. As far as I am concerned it would help solve the problem just as well if this Government were willing to do some of its business on a dual-entry bookkeeping system. But I have lost all hope of that. I don't see any prospect of this Government doing business on that basis. Is there any such prospect?

Mr. CHAPOTON. I think there is very little prospect of that.

Senator LONG. Because if there were, it would seem to me that that would have a better possibility, just as I think the Government could do a lot better job in research if it could pay the same kind of money for its talent that a private organization pays for research talent. But under our pay schedules we simply cannot do it. So, once again, to get the best talent that can be had to develop new products, new weapons, new techniques, we have to hire a contractor who is in a position to pay far greater rewards than this Government could pay for the same type talent. We do it, don't we?

Mr. CHAPOTON. Right.

Senator LONG. And we have no recommendation available to us that is feasible to answer that problem except by hiring a contractor to do something which otherwise we might want to do for ourselves.

Thank you very much.

The CHAIRMAN. Senator Chafee?

Senator CHAFEE. I have no questions, Mr. Chairman, I would just like to congratulate you for the introduction of this legislation. I must say it's an area that I had not been familiar with.

I think there are, as these hearings will bring out, some problems with the exact effective date. I'm looking forward to the testimony of the Assistant Secretary for the Navy on that subject, because I know the Navy has some specific problems with the effective date. Nevertheless, the overall thrust of the legislation is something I certainly agree with.

Thank you.

The CHAIRMAN. Senator Grassley, do you have questions?

Senator GRASSLEY. No; but I have a statement I want to put in the record.

The CHAIRMAN. Fine. I appreciate your cosponsoring the legislation.

Mr. Chapoton, there will be a followup, because there has been some concern by some of the House Ways and Means Committee that the administration effectively pulled the rug out from under them over on the House side. It makes it very difficult to try to close some of these glaring loopholes if the administration has changed its position after testifying over there.

You have indicated that you still support the bill.

Mr. CHAPOTON. Mr. Chairman, I met with Mr. Pickle yesterday. I think that situation is cleared up.

The CHAIRMAN. But there is some change in your testimony, and there is some difference of opinion whether it is $1 billion loss of revenue because of the personal property change or whether it is much greater than that. I think that's an area we need to address. I know what the estimates say, but that doesn't mean they are accurate.

Mr. CHAPOTON. I did not know there was a difference of opinion on that. I would like to get to the bottom of that.

The CHAIRMAN. Our next witnesses will be the Navy and the Air Force: Everett Pyatt, Principal Deputy Assistant Secretary; and Lloyd Mosemann, Deputy Assistant Secretary, Air Force.

Let me indicate as I did earlier that because we have 19 witnesses that your statements will be made a part of the record. You are both accessible to the committee, you are in Washington, D.C., and we would ask that you summarize your testimony so it will leave time for questions. I know Senator Chafee has some questions in this area, so that will give us time for questions; otherwise we do not need you to read the entire statement. That is the point.

Mr. Pyatt?

Mr. PYATT. Yes, sir.

STATEMENT OF HON. EVERETT PYATT, PRINCIPAL DEPUTY ASSISTANT SECRETARY, SHIPBUILDING AND LOGISTICS, DEPARTMENT OF THE NAVY, WASHINGTON, D.C.

Mr. PYATT. I will briefly summarize my statement and submit it for the record.

The Navy's TAKX and T-5 programs, follow approximately 30 prior ships that have also been built using the same methodology in the business environment that pertained at the time.

This is not a new program for the Navy, and I would like to have it explored in that environment, if it is possible.

We are extremely concerned that the current draft with the cutoff date, the inservice date of January 1984, would effectively devastate the two programs that we have worked on in the last 1½ years with the approval of Congress. These programs have created tens of thousands of jobs in a very depressed industry, preventing the closing of at least three shipyards. They meet vital defense requirements for sealift capabilities. They will save the Government hundreds of millions of dollars because we have been able to package the programs in a very intense competitive environment for both construction and for operation.

At this time the programs are well underway, with the contractors having expended over $400 million and having obligated hundreds of millions more for material. Two of the ships being converted have already been cut in half in preparation for the modifications.

There have been numerous studies made that we presented to the Congress in going through the requirements of the 1983 Authorization Act. Others have been made, and these come up with a divergence of answers. I think this underlies the importance of the amendment to require the executive branch to set up some standards for evaluation of leasing.

We had a very difficult time in doing our evaluations to lay down a consistent set of guidelines that provided for an honest evaluation.

We are hopeful that this committee will be consistent with the amendment that I believe you sponsored the other day, No. 1440 on the defense authorization bill, and that you will continue to support these two programs with the appropriate level of congressional oversight.

Overall, I believe the existence of the Navy need for these shipping services, combined with the existence of the tax incentives that pertained at the time for investment, provided a legitimate means to sustain a vital commercial sector of the shipbuilding industry, during the period of transition from Federal subsidy. Without this partnership the national shipbuilding base would consist only of yards building military ships, and I believe that would have a severe national impact.

The CHAIRMAN. Mr. Mosemann?

[The prepared statement of Hon. Everett Pyatt follows:]

STATEMENT OF EVERETT PYATT, PRINCIPAL DEPUTY ASSISTANT SECRETARY OF THE NAVY (SHIPBUILDING AND LOGISTICS) BEFORE THE SENATE COMMITTEE ON FINANCE ON THE NAVY'S TAKX AND T-5 PROGRAMS, JULY 19, 1983

Mr. Chairman and Members of the Finance Committee

I am Everett Pyatt, Principal Deputy Assistant Secretary of the Navy for Shipbuilding and Logistics.

It is a pleasure to appear before you to discuss the Navy's TAKX and T-5 Tanker build and charter programs, in the context of S. 1564.

I realize that the focus of this Committee is primarily directed at the Federal tax aspects of these programs. However one should not consider legislative action which could substantially affect these existing programs and preclude future such programs without a thorough understanding of the many significant features and benefits of these programs.

Historical Background and Congressional Policy

Throughout this country's history the Navy has successfully relied on the U.S. merchant marine for the carriage of vital materials and supplies in times of conflict and war. In 1936 Congress established a policy of development and maintenance of a merchant marine capable of serving as a naval and military auxiliary in time of war or national emergency. This has mandated the Navy's reliance and dependence on the U.S. merchant marine to meet the majority of its ocean transportation needs during both peace and war.

The Navy normally has from 50 to 70 privately owned and operated U.S. flag vessels under charters of various types and lengths. In war time this number has in the past and would in the future expand to exceed 400 vessels. The vast majority of these vessels were built in U.S. shipyards with private financing, utilizing the full tax incentives provided by Congress from time to time to encourage and promote capital investments.

The "Build and Charter" method, whereby new ships are built and on completion chartered to the Navy, is not a new concept. Prior to the recent TAKX and T-5 tanker program, the Navy has, with the foreknowledge and approval of Congress, used the build and charter method to obtain the services of one cargo ship and 29 tankers under programs dating back to 1952. The concept has proven valuable and a proper reliance on the merchant marine to furnish goods and services needed by the Navy. It avoids Navy competition with the private sector for merchant marine services while providing the Navy with the benefit of the considerable expertise in the industry in regard to the design, construction and operation of cargo ships and tankers.

The TAKX and T-5 tanker build and charter programs are thus extensions of several decades of experience and are fully consistent with the express mandate of Congress to rely on the U.S. merchant marine to the full extent practicable. The contractors are not merely building ships for the Navy's use; but rather they are providing a total transportation service. The Navy's solicitation described the type and quantity of the cargo to be carried, the operational requirements and the unique features necessary to perform the services associated with the prepositioning, care and delivery of Marine Corps equipment in the case of the TAKX vessels and the worldwide distribution, including Arctic and Antarctic regions, of clean petroleum products in the case of the T-5 tankers. The contractors are responsible for designing, constructing, supervising, financing, manning, training, operating, and maintaining the vessels, and for the care and custody of the cargo and delivery where and when needed throughout the entire 20 or 25 year charter periods. These vessels are not combatants, nor do they operate in direct support of the fleet.

Benefits of Build and Charter Procurements

The plan to rely on the Merchant Marine and charter the TAKX vessels was developed in the Navy, approved by the Secretary of Defense and Office of Management and Budget, then submitted to the Congress as part of the FY82 program. The build and charter program provided a number of significant advantages and benefits for the Navy, the Government as a whole and the private industry which would not have been available, at least in the same degree, if the Navy had built or purchased the vessels itself. Before discussing those advantages and benefits in detail, it should be noted and emphasized that only a commercial type vessel is a suitable candidate for such a build and charter program; it would simply be unworkable to attempt to build and charter a warship or fleet auxiliary.

A significant advantage of the build and charter method is that it permits the utilization of commercial specifications, commercial construction contracts, and commercial supervision and standards, rather than military, with attendant reductions of at least $450 million in the cost of constructing the vessels. These features accelerated the construction phase of the program by approximately 18 months. This acceleration was absolutely vital since it satisfied the Marine Corps' requirements for the prepositioning of the first MAB's equipment around the end of FY84. It was also vital to the industry since the TAKX contracts, which were awarded in August 1982, provided more than 12,000 shipyard jobs and many thousands more for material and equipment vendors, prevented the imminent closing of at least three shipyards, avoided potential default under Government guaranteed notes of approximately $100 million for three of the ships and avoided potential inflationary increases in 1986 and 1987.

The Build and Charter method provides a totally integrated operation from start to finish. The contractors -- who will man and operate the vessels -- and bear the attendant risks if the vessels are not safe, efficient and reliable, are also responsible for the design, construction contracting and supervision of the vessels. Selecting the successful contractors for a totally integrated package in a highly competitive time and manner achieved substantial union concessions and reductions for the construction and operation of the vessels which will save more than $500 million over the life of the charters.

Under the TAKX and T-5 tanker contracts the private parties, not the Navy, have assumed full responsibility for construction cost overruns, late equipment or material, defects or errors in design and other risk elements which have often resulted in claims against the Navy under Navy construction programs.

Under the Build and Charter program the Navy is not obligated to pay a single cent unless and until a completely satisfactory vessel is built, fully manned and in all respects ready to commence performance of the required service. The payment of charter hire, rather than purchasing the vessels, allows the Navy to match its expenditures with the actual utilization of the vessels over 20 or 25 years. This spreading of the costs, which does not even commence until after construction of the vessels, avoids multi-billion dollar budget impacts in FY83, FY84 and FY85 and competition for appropriated funds which are urgently needed to fund weapon systems and combatants. Moreover, this program was conducted at the strong suggestion of the House Appropriations Committee and under the guidance provided by the 1983 Defense Authorization Act.

We also firmly believe, for reasons which I will discuss in more detail later, that chartering these ships is less expensive on a present value basis, not only for the Navy, but for the Government as a whole, taking into consideration all tax inflows and outflows to the Treasury.

Congressional Review of TAKX and T-5 Tanker Programs

The Navy understands the very legitimate concern and desire of this Committee and others to control leasing by Federal agencies to ensure that such procurements are not abused. When the Navy indicated its intent to secure the services of TAKX vessels and T-5 tankers, the Congress recognized the special situation involved and included provisions in the FY83 DOD Authorization Act for Congressional review of the charter versus purchase decision. Specifically included in Section 303 of the Act was the requirement that the Navy notify "the Committees on Armed Services and on Appropriations of the Senate and the House of Representatives of the proposed lease" and the lapse of a "period of thirty days ... after the date on which such Committees receive such notification." Section 303 further provided that "any such notification shall include a description of the terms of the proposed lease and a justification for entering into such a lease rather than obtaining the vessel involved by acquisition."

Regarding the TAKX, Congressional review included a study by the House Appropriations Committee Surveys and Investigations Staff, hearings by the House Armed Services Readiness Subcommittee and staff reviews by the Armed Services and Appropriations Committees of the Senate and House. All four Committees provided written concurrence with the Navy plan to finalize the conditional awards for its chartering program made in mid August 1982.

I would like to submit for the record the letters containing the concurrences of the four Committees, along with the report of the Surveys and Investigations Staff. Three of the Committee letters, and the financial analysis, were previously made part of the record of the Readiness Subcommittee hearing of September 17, 1982.

The economic analysis of the T-5 Tanker program which was submitted to Congress on September 30, 1982 showed the same results as the TAKX analysis. The T-5 program subsequently received written endorsement from three Committees and the fourth allowed the 30-day review time stipulated by law to expire. The Navy waited an additional 53 days before notifying the contractor to proceed. This decision to proceed at that time was made to avoid the increased program costs for the contractor and the Navy which would have resulted from further delay.

Status of TAKX and T-5 Tanker Programs

Thus the Navy entered into binding contracts for the building and long term chartering of the 13 TAKX vessels and five T-5 tankers after extensive Congressional review and approval of the Oversight Committees in the Senate and House. The construction phase of the programs is well underway. The four Navy prime contractors (Maersk Line Ltd., Waterman Steamship Corporation, General Dynamics Corporation and Ocean Carriers, Inc.) have executed binding construction contracts and entered into $2.2 billion in revolving credit agreements with four bank syndicates having 50 member banks. To date the contractors and shipyards have expended over $400 million in converting or constructing the ships and placed many hundreds of millions of dollars in orders for steel, equipment, components and other material. Five of the existing ships being converted for the TAKX program have been delivered to the shipyards and two have already been cut in half in preparation for addition of midbody sections.

Nature of the Financial Structure

When the ships are completed, the revolving, short term loans necessary to finance construction must be repaid. The contracts were entered into on the assumption that at such time the permanent financing, on a standard leveraged lease basis, would be in place to repay the construction loans. If a leveraged lease financing cannot be arranged due to the unwillingness of private investors to make the necessary equity investments then the Navy must either: (1) terminate the contracts for convenience and pay all costs incurred or (2) purchase the vessels, which would require an appropriation of approximately $2.7 billion by Congress or (3) allow the contractors to finance the vessels with the sale of 100% debt, which would add approximately $3 billion to the Navy's charter hire obligations.

In a standard leveraged lease transaction the private investors, or lessors, invest 20-45% of the capitalized cost of the equipment as equity, and borrow the remaining 55-80% from lenders. The owner-lessor is encouraged in large part to make such equity investments by the various tax incentives provided by Congress. These include Accelerated Cost Recovery System deductions ("ACRS") which is five years for vessels and may or may not include a 10% Investment Tax Credit ("ITC"). The owner-lessor leases or bareboat charters a vessel to the lessee, who uses the vessel to provide the transportation services to the Navy under the Time Charters. The rent or charter hire which a lessee must pay to a lessor, and which the Navy in turn must pay to a lessee, is substantially reduced in reflection not only of the tax incentives received by the lessor but also the sinking fund investment earnings the lessor realizes from such tax benefits. Thus the user of the vessels and the ultimate beneficiary of the services they will provide, the Navy, realize substantial savings in the cost to them of the vessel and services provided.

The Navy's Program acheives the Goals intended by Congress

There is no question that the Navy's chartering program fully complies with the policy established by Congress in the Merchant Marine Act of 1936, and had the specific approval of the Oversight Committees. However, there has been some criticism in recent months from the press and a few members of Congress, over the fact that the Navy, by chartering the vessels, obtains their services at substantially reduced costs due to the availability of the ITC and ACRS deductions for the owner-lessors. Aside from the fact that we believe that a proper analysis of the total cost to the Government shows that chartering is less expensive than leasing, we submit that even if that were not the case, the intent of Congress in providing the various tax incentives has been fully achieved in the TAKX and T-5 tanker programs. Without the charter hire reductions resulting from those tax incentives, it is extremely doubtful that investors would be willing to make the necessary equity investments, and it is certain that the Navy simply could not afford to charter the vessels nor is it likely that Congress would appropriate procurement funds given its past direction to use the charter method. Thus the many other benefits of a charter program would not be obtained and the vessels probably would not have been built at this time. It follows then that tens of thousands of jobs in an extremely depressed industry would have been lost, several shipyards vital to the

Nation's industrial base would have been closed and the Navy would have been unable to satisfy its requirements for Maritime Prepositioning Ships nor replace its existing obsolete 25 year old T-5 tankers. The fact that the Navy is a beneficiary of the various tax incentives provided by Congress should not be allowed to obscure the fact that private investments will be made for capital assets built in this country and thousands of jobs are created.

We submit that this complies with the intent of Congress in providing the tax incentives and must be distinguished from paper transactions under which tax-exempt entities merely sell and lease back existing capital assets. The distinction between leasing by Federal agencies versus other tax-exempt entities and the type of lease transactions should be carefully drawn. In a dramatic but limited manner this program has acheived the goals of the 1982 tax laws of promoting employment and industrial growth.

Tax Indemnities

The Navy has been criticized for having agreed to undertake a limited tax indemnity at the insistence of the financing institutions participating in the TAKX and T-5 transactions. In fact, in the statements introducing S. 1564, it is suggested that a lease might be considered acceptable so long as it contains no tax indemnities.

This is perhaps the most misunderstood aspect of the whole leasing discussion. As I mentioned above, the rationale for leasing is based on the premise that the lessor will receive certain tax benefits established under the tax code relating to its investment, and that the value of those benefits is reflected in reduced rentals payable by the lessee. Thus, in our case, what is lost by the Treasury is recouped by the Navy. The lessor receives a fixed rate of return based on that premise.

All that a tax indemnity does is to provide that if those expected tax benefits become unavailable because of the structure of the transaction or because of some actions taken by the Navy which were not contemplated by the agreements, the Navy will compensate the lessor for the loss, so that the lessor's return will remain as planned. The most significant--and overlooked--point is this: if the Navy should ever have to pay an indemnity, it merely means that the Treasury has not had as much of a revenue loss as was contemplated, and that the entire amount paid by the Navy simply ends up in the Treasury.

The existence of such a tax indemnity in the contracts permits the transaction to be priced at the lowest cost to the Navy. The real irony is that, if no tax indemnity provisions were included, (i) the rentals would have to be priced at higher levels to assure the lessors of their return, (ii) the tax benefits would likely prove to be available anyway, giving the lessors a windfall, and (iii) both the Navy and the Treasury would lose.

Three additional points should be mentioned. First, our feedback from the financial community indicates that through its negotiations the Navy has provided one of the most limited tax indemnities, compared with the usual leveraged lease, while still preserving the rent reduction.

Second, one provision of the TAKX and T-5 contracts--which has been generally mischaracterized as an indemnity--has taken on considerable importance. This is the provision that adjusts the rental payments if the levels of contemplated tax benefits are changed as a result of changes in the tax laws made after submission of the best and final offers and prior to delivery of the ships. This provision was included to protect both the Navy and the lessors--neither can obtain an unanticipated benefit if the law is changed. Such a provision is quite standard in transactions of this type, but it is particularly important here precisely because of the Bill before you.

Third, the accusations that the Navy has agreed to pay all of a lessors' legal costs in future litigation with the IRS is a gross and inexcusable distortion of the contractual provisions. The Navy has only agreed to reimburse the lessor's legal expenses in contest actions with the IRS initiated at the express request and direction of the Navy. It must be kept in mind that the Navy has provided only a very limited tax indemnity, so that in the event of a disallowance of tax benefits by the IRS it may be necessary to initiate a "contest action", which could include further administrative action rather than litigation, to delineate and clarify the extent of the disallowance due to causes for which the Navy is responsible as distinguished from other causes. It is inconceivable that the Navy would ever request litigation against the IRS to challenge the propriety of a disallowance. If a lessor initiated such litigation, the legal expenses would be entirely for its own account.

Recommendations

The TAKX and T-5 tanker Build and Charter programs have provided unique and substantial benefits to the national industrial base, military readiness and the merchant marine.

The TAKX and T-5 programs were approved in accordance with legislation and were awarded under contract prior to the May 23, 1983 effective date provided in the bill. The effective date provisions of the bill appear to be designed in general to permit to go forward those programs with respect to which substantial time, effort and monies have been committed. However, this provision as presently drafted adds a further qualification that applies only to Federal leases -- that the asset must be placed in service before January 1, 1984. This addition is completely unworkable, and defeats the purpose of the binding contract cut-off date, for any long lead time assets. The TAKX and T-5 ships are scheduled to be delivered and placed in service from 1984 through early 1986. Since the contracts are already in place, the effect of the provision would thus be to require either an appropriation by Congress to buy the ships or a cancellation of the program, either of which at this point would be a substantial and needless expense. In short, this provision upsets negotiations and contracts undertaken in good faith and would inflict devastating effects on the program.

STATEMENT OF HON. LLOYD K. MOSEMANN, DEPUTY ASSISTANT SECRETARY, LOGISTICS AND COMMUNICATIONS, DEPARTMENT OF THE AIR FORCE, WASHINGTON, D.C.

Mr. MOSEMANN. Thank you, Mr. Chairman.

The Air Force has not previously leased on a long-term basis any major operating equipment such as aircraft.

About a year ago we received an unsolicited proposal from Cessna Aircraft Corp. for replacement of our CT-39 operational support aircraft on a lease basis at a cost which will be substantially less than the cost of continuing to operate and maintain our existing 20-year-old aircraft.

We did not accept that unsolicited proposal, but we did continue to evaluate the concept, and we found that modern business jets such as those that are now available from contractors such as Cessna could be maintained at one-fifth of the cost, and with fuel savings on the order of 35 to 50 percent, or about $70 million over 8 years.

Our cost analysis, using methodology concurred in by the Treasury Department and based on that unsolicited proposal, indicated that in this instance a lease, even considering the cost to the Treasury of accelerated depreciation allowances, would be cheaper than buying. This is basically because of the depressed condition of the small executive jet-type aircraft industry in America today, and appears to be a one-time opportunity.

We do support the intent of the bill, in that there is need for a clearer methodology and policy; but, in view of our having congressional authority for this competitive procurement, in view of the fact that we have received competitive proposals which are now in a source-selection evaluation, we would like to see the effective date of the bill adjusted or some other accommodation to permit us to proceed with this one-time program which has been approved and authorized by the Congress.

Thank you, Mr. Chairman.

[The prepared statement of Hon. Lloyd K. Mosemann follows:]

STATEMENT OF HON. LLOYD K. MOSEMANN, DEPUTY ASSISTANT SECRETARY, LOGISTICS AND COMMUNICATIONS, DEPARTMENT OF THE AIR FORCE

Mr. Chairman, I appreciate the opportunity to provide the Committee with background information concerning Air Force long-term leasing of high-cost property.

The Air Force really has had virtually no such lease arrangements. We have leased automated data processing equipment (ADPE), vehicles, and some family housing; the latter primarily in overseas areas. With these exceptions, which it is my understanding the Committee does not plan to address in these hearings, we have had no long-term leases for major equipment. Frankly, until recently, it has been our belief that it is cheaper to buy and own rather than to lease. Even with respect to Automated Data Processing Equipment, we are more and more either buying the equipment outright or are leasing for a short period after which we exercise an option to purchase. However, we are now considering several lease programs. In our two approved programs, we concluded that lease is the most responsive means by which to satisfy some rather unique, or atypical, Air Force mission requirments.

I will discuss two lease projects which we are currently pursuing with Congressional authorization, and then address the specific conceptual questions which were provided to us prior to the hearing. The two lease projects which we are currently pursuing involve the C-140B and CT-39 replacement aircraft programs.

Specifically, we have a program to obtain three aircraft on a short term lease arrangement of one to two years for use in the 89th Military Airlift Wing, what we call the Special Air Mission (SAM) fleet located at Andrews Air Force Base. We also have authority to proceed with a second program to lease 120 aircraft as replacements for the CT-39 aircraft.

Congress has advised us for the past two years to acquire replacements for the aging, range- and payload-limited C-140B aircraft currently operated by the 89th Military Airlift Wing at Andrews Air Force Base and Ramstein Air Base, Germany. The requirement is for a fuel efficient aircraft capable of carrying at least 14 passengers over transcontinental ranges. We recognize that replacement is long overdue, and are pursuing that acquisition through normal procurement channels. There are commercially available off-the-shelf aircraft that satisfy the requirement. However, we have found that they can be obtained one year sooner by leasing the first three of eleven aircraft at a cost within current budget constraints. Our acquisition strategy of a short-term lease followed by purchase in FY 85 provides the greatest capability in the shortest time, and is consistent with Congressional direction. We have completed the SAM source selection and awarded a contract to Gulfstream Aerospace on June 6, 1983 for the lease of three Gulfstream III aircraft with an option for purchase in FY 1985. After purchasing these three aircraft, we plan to purchase an additional eight aircraft to replace the eleven C-140B's presently in our inventory.

We also have explicit Congressional authority to proceed with a second program to lease 120 aircraft as replacements for the CT-39 operational support aircraft. In the Continuing Resolution Authority there is text tying the CT-39 replacement to another program for European Distribution System (EDS) aircraft. However, the two programs are, in fact, separate and distinct, and require aircraft of distinctly different capability. We plan to procure the EDS aircraft in the traditional acquisition manner, and I will not address it further here.

The CT-39 replacement program is aimed at replacing 22 year old, six passenger Sabreliners with an equivalent off-the-shelf executive jet. The minimum requirement is for 120 operational support aircraft. Operational support aircraft have an amalgam of time sensitive wartime contingency missions including command and staff movements, medical and security personnel transport, and intelligence support. In peacetime, they provide low cost flying experience for recent graduates of pilot training. (We currently have 136 CT-39s, most of which are used in various operational support roles, but also include two for checking navigation aids, ten for various experimental and research purposes, and four in the Air National Guard. Our present plan is to keep the latter sixteen.)

The existing CT-39 airplane, because it is old, has numerous problems. In the last ten years we have had three major structural refurbishment programs, and the end is not in sight. If we keep the airplanes in service, we are faced with an estimated $120 million bill for accomplishing major wing reskinning, corrosion control and minor structural repairs within the next five years. In addition, because the aircraft is so old, it is fuel inefficient.

We have discussed replacement of the CT-39s almost every year for the past five years; however, in a military environment already short of combat arms, the CT-39 replacement has not successfully competed with higher priority requirements.

Our thinking, however, changed dramatically last summer when we received an unsolicited proposal from the manufacturer of small business jets of the type that could be an off-the-shelf replacement for the CT-39. This proposal contained some interesting facts and figures; namely, that we could lease new aircraft, obtain contractor maintenance of these aircraft, and operate the aircraft within the same level of funding that we are spending today for maintenance and operation of the CT-39 fleet.

As we studied the proposal, three things became obvious:

1. The proposal was fiscally attractive. Its attractiveness derived in some measure from the depressed condition of the aircraft manufacturing industry, which permitted the contractor to give us a rock bottom price for the new aircraft - hence a "window of opportunity" exists for at least a short period.

2. It would not be appropriate to award a sole source contract on the basis of the unsolicited proposal, as there are other equally capable off-the-shelf aircraft that could be used to replace the CT-39.

3. We needed explicit Congressional authorization to enter into a long term lease contract.

We rejected the unsolicited proposal, but requested Congressional authority to enter into the lease arrangement. This was granted in the Continuing Resolution Authority. Additional funds were not requested, because the lease arrangement will cost us no more than the operation and maintenance of the existing CT-39 aircraft.

Our present schedule calls for contract award by the end of September 1983 providing for aircraft deliveries at the rate of four to eight per month beginning three to six months later. The competitive request for proposal (RFP) was issued on March 30, 1983; contractor responses to the RFP were received on May 16, 1983 and we are presently evaluating the proposals. The terms of the lease will be for five years (with an additional three years optional). The Air Force is considering several alternatives regarding possible later purchase of the aircraft.

Now let me try to address some questions that seem to deal more specifically with the philosophy of leasing. As I mentioned, the Air Force has had little experience with this acquisition method. In our two approved programs, we were driven more by exigency and need than by cost trade-offs between buying and leasing. However, now that we have kind of backed into the leasing business, we are beginning to address more directly the question of whether leasing is an acquisition approach that we should more frequently consider. We are therefore, beginning to consider the philosophical and economic issues that, I believe, are the concern of this Committee. In this regard, we have found OMB Circular A-104 not totally useful, because, stictly speaking, it relates only to the lease or purchase of real property. However, in the absence of other policy guidance, we have reviewed Circular A-104 and are taking an approach which is generally consistent with that Circular.

We are considering the impact that the tax incentives in a leasing arrangement would have on the total cost to the Government in the case of the CT-39 replacement. The question is how much of the tax losses can be directly attributed to these Air Force initiatives?

The exact tax implications are difficult to quantify. Compounding the difficulties in quantifying the tax implications to the Goverment, especially in the CT-39 Replacement Program, is the tax-loss position most of the United States aircraft manufacturers are in today. We have, however, developed a methodology that quantifies the various tax questions and results in a total cost of leasing to the Government. This methodology has been applied to the CT-39 replacement program with the result that leasing is economically beneficial in this particular case when compared to continuing operation of the existing CT-39 fleet.

Although leasing may offer savings in total costs to the Government, and we may recommend it as a procurement strategy in certain future programs, we are fully aware that enabling Congressional legislation is required on a case by case basis before we can implement any long term leasing program, since the existing statutory authority permits leasing for only one year. All procurement programs, no matter how structured, will be reviewed and approved by the Air Force, OSD, and OMB internal program and review processes, before going to Congress for final approval. However, to the extent that no additional funds are required, as in the case of the CT-39, specific line item appropriation is not required. The funds, of course, are reviewed at all levels as a part of the justification for the overall Appropriation for Operation and Maintenance. Therefore, our leasing experience does not indicate a divergence from the normal weapon system acquisition approved processes.

In summary, let me say again that we do not see leasing as a major component of our major systems acquisition programs. Until recently, leasing has not been an attractive alternative to the traditional acquisition process. But now it appears that leasing may be a viable alternative in certain systems acquisitions, particularly where the system is commercially available off-the-shelf. Very few of our programs have this characteristic. Further, we believe that leasing should be considered on a case by case basis only when justified as being in the best interest of the Government by appropriate mission impact and/or cost benefit analysis, which includes consideration of the net cost to the Government.

The CHAIRMAN. Senator Long?

Senator LONG. No questions, Mr. Chairman.

The CHAIRMAN. Senator Chafee?

Senator CHAFEE. Thank you, Mr. Chairman.

Mr. Pyatt, did you say that you've got before this committee some recommendations to take care of your particular problem?

Mr. PYATT. In the Defense Authorization Act on the Senate side, an amendment was introduced and passed 93 to 0 that would——

Senator CHAFEE. Could you speak a little louder?

Mr. PYATT. I'm sorry.

In the discussion of the Defense Authorization Act, an amendment on the TAKX and on leasing programs was introduced and passed. We think that's a fine resolution, regarding the TAKX and T-5 programs.

In this particular bill there is a placed-in-service date that is contradictory to the Defense authorization amendment. It would require the ships to be placed in service before January 1984. That is impossible.

Senator CHAFEE. Well, I appreciate that, but we don't want to have this bill in contradiction to the DOD authorization. How can we straighten out this to take care of your problem?

Mr. PYATT. Strike the placed-in-service date of 1984.

Senator CHAFEE. And put in what?

Mr. PYATT. I think the way it is now written is that the contracts have to be completed by May 23, 1983, and that is satisfactory in this case.

Senator CHAFEE. The contract has to be completed.

Mr. PYATT. We have completed those, and the testimony of Treasury suggested that any program approved by the Congress prior to the same date should be approved for execution, and we support that, too.

Senator CHAFEE. But this legislation will apply to all future contracts?

Mr. PYATT. In the future, the way I understand it, is that it sets down a new set of principles by which to evaluate charters. The Navy has conducted charter programs under a variety of rules in the past, and it would become the new set of rules that we have to work with. And that's fine.

Senator CHAFEE. OK, fine. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Long?

Senator LONG. I want to ask a question of Mr. Mosemann. It would seem to me that a lot of private equipment could be available to the military. I have in mind jet aircraft, the type of which can be used in peacetime for executive travel but which you would be needing in the military during wartime. There is a lot of equipment like that that would be needed in wartime, is there not?

Mr. MOSEMANN. That is correct; we do have a wartime requirement, yes, sir.

Senator LONG. It seems to me that, rather than the Air Force having to maintain all that equipment and keep it up, you ought to have some kind of arrangement where people would be privileged to use some of that equipment; but in the event the Nation found itself at war, this Nation ought to just take it, just like you would take a ship if you needed it, and tell those executives, "That's just too bad, but instead of flying around by jet we've got a propeller plane over here that you can use to get where you need to go." In view of the fact that we were at war, I would think that you ought to treat business the way we did in World War II. When we went to get on an airplane, the question was, "Is this trip really necessary? Do we have to put you on an airplane to get you there? Maybe you ought to take the bus."

So I would think there ought to be a way to program a great deal of aircraft that could be available to you for whatever use the service might have, which would be kept up and maintained in peacetime and where, if necessary, you would not only claim the airplane but you would claim the mechanics for maintenance and all the rest of it. Are you doing that type of thing currently?

Mr. MOSEMANN. Yes, sir. Let me give you two answers to that question. With respect to large airplanes like the 747 and the DC-10's and the DC-8's, we do have such arrangments with the airlines; it's called the civil reserve aircraft fleet program. There are over 100 airplanes that are available to us under contract in wartime which are flown in commercial service in peacetime.

Now, insofar as the small operational support aircraft is concerned, I think such arrangements would be considerably more difficult. Second, we have a peacetime requirement to use those airplanes to maintain the proficiency of our pilots. We can maintain the proficiency of a pilot in a CT-39-type airplane, a small business jet-type airplane, at considerably less cost than in an expensive fighter airplane or in a bomber. So there is a reason for us to have these airplanes in peacetime, sir.

Senator LONG. You said you have 100 planes available to you. I can recall in World War II that that DC-3 was a great plane. I think you might have called it something else. What did you call it?

Mr. MOSEMANN. A C-47.

Senator LONG. You called it a C-47, and the airlines called it a DC-3. That was usually referred to as the workhorse of the airlines. Back at the time the war broke out, that was the most useful plane the airlines had. And nowadays it would be some other plane.

It seems to me that for a plane to fulfill a parallel function, you ought to be claiming a lot more than 100; there ought to be a thousand of those type of planes that you ought to at least be able to lay your claim on the day you found yourselves in a major war.

Mr. MOSEMANN. Yes, sir. There is really a two-step process. We have contracts with the airlines to take over their airplanes within 24 hours, and additional ones within 72 hours. For aircraft not under CRAF contracts with the Air Force, the Department of Transportation performs the function that you have just described; any residual airplanes, all the ones we haven't taken immediately, they then take under their responsibility, and they allocate them either to defense needs or for urgent national domestic priorities.

So, all of the airplanes that you are alluding to do come under the control of the Government. It is the Department of Transportation which executes this authority except for those that we have these CRAF contracts with in peacetime, sir.

Senator Long. It would seem to me that if the service were willing to sign on to a pooling contract where you would simply use a plane a certain period of time, sign up for a certain number of hours, that would help make possible the pooling of various airplanes, where private interests could put their money in, and you would have a lot of equipment that you would otherwise not have available to you.

Mr. Mosemann. I see your point.

The Chairman. Senator Grassley?

Senator Grassley. In regard to the leasing of ships, is this a relatively new arrangement in the recent 3 or 4 years, or is this something that goes back over a long period of time for the Navy?

Mr. Pyatt. You can find various versions of it for about 200 years. In today's formulation, it is since about 1950. Before these two programs, we had undertaken 30 ships, which I can furnish for the record.

[The information follows:]

Following is a listing of 30 ships that have been included in the build and charter programs of the Military Sealift Command since 1952:

Year	Number	Type of ship	Ship name
1952	4	29,000 DWT tankers	Orion Planet, Orion Clipper, Orion Star, Orion Comet.
1957	2	32,300 DWT tankers	Eagle Traveler, Eagle Voyager.
	2	26,500 DWT tankers	Eagle Courier, Eagle Transporter.
	2	32,000 DWT tankers	Saroula, Barbara Jane.
	1	32,650 DWT tanker	Hans Isbrandtsen.
	1	65,000 DWT tanker	Orion Hunter
1961	1	26,000 DWT tanker (reconstruction),	Shenandoah.
1965	1	RO/RO	GTS Adm. William M. Callaghan.
1971	1	37,500 DWT tanker	Spirit of Liberty.
	4	37,200 DWT tankers	Falcon Lady, Falcon Duchess, Falcon Princess, Falcon Countess.
1972	9	25,000 DWT tankers	Sealift Atlantic, Sealift Pacific, Sealift Arabian Sea, Sealift China Sea, Sealift Indian Ocean, Sealift Mediterranean, Sealift Caribbean, Sealift Arctic, Sealift Antarctic.
1981	2	34,000 DWT tankers	Falcon Leader, Falcon Champion.

Senator Grassley. OK.

Is the number of 30 ships a number that has increased dramatically in just the last 3 or 4 years?

Mr. Pyatt. Yes, sir; the programs that we were talking about today, the TAKX and T-5 programs, total 18. The total is 30 plus 18, or 48.

Senator Grassley. In regard to the expansion of it in recent years, can you tell me whether or not the impetus for the Navy doing this has come from within the Defense Department, or is it something that has come from without the Defense Department?

Mr. Pyatt. It is from within the Defense Department. In looking at the two particular programs, one is the prepositioning of material for the Marines and the other is a program for replacement of old tankers. We have taken it to our appropriations committees, and they have suggested, "Look into chartering these ships." That's how the evolution started.

It turns out that the ships currently are manned by merchant mariners and not by Navy people, and so it was a logical extension of current operations to turn to the merchant marine for the acquisition and provision and operation of the ships.

Senator **Grassley**. Has the current high interest rate problem and the difference between tax-exempt as opposed to long-term interest rates had a beneficial impact to the Defense Department on pursuing this arrangement?

Mr. **Mosemann**. We are not involved in the tax-exempt bonds at all.

Senator **Grassley**. I know that.

OK. Thank you very much.

The **Chairman**. Mr. Pyatt, before granting a broad tax indemnity against the loss of any tax benefits claimed by the private investors in the TAKX, did the Navy obtain an IRS ruling or advice from the Treasury, or even a private legal opinion that such benefits would be available?

Mr. **Pyatt**. We did not obtain advice from the Treasury because we were told only the taxpayer may receive those rulings. We are not the taxpayer in this case.

We did look at similar situations in the past, and a limited number did receive rulings. We knew of no rejections.

The **Chairman**. I have one question for Mr. Mosemann.

What are the differences between the Air Force bids to lease the replacement for the CT-39's and the Navy lease on the TAKX? And why didn't you include a tax indemnity?

Mr. **Mosemann**. Well, basically, we are leasing the airplanes in what is known as a "dry lease"; that is, we would receive the airplane and would receive the maintenance of the airplane; but we the Air Force will fly them with our own pilots, and we will put the fuel into the airplanes. That is not the case so far as the Navy is concerned.

So the only benefit under existing tax law that our lessors would receive would be from the accelerated depreciation allowance.

The **Chairman**. Well, again, as I have indicated, we probably will have additional questions of both witnesses as we get into trying to deal with this rather massive loophole, and we appreciate your testimony.

Mr. **Mosemann**. Thank you very much.

The **Chairman**. We next have a panel consisting of Daniel Bratton, president of Kansas Wesleyan College of Salina, Kans.; Michael Hooker, president of Bennington College; and Paul Oosterhuis of Hogan & Hartson, on behalf of the Computer & Business Equipment Manufacturers Association, Washington, D.C.; and Donald C. Alexander, Esq., partner, Morgan, Lewis & Bockius, on behalf of the Chamber of Commerce of the United States.

Mr. Bratton, let me again indicate that the entire statements will be made a part of the record. I guess you will proceed in the order you have been called.

STATEMENT OF DANIEL L. BRATTON, PRESIDENT, KANSAS WESLEYAN COLLEGE, SALINA, KANS., ON BEHALF OF THE NATIONAL ASSOCIATION OF INDEPENDENT COLLEGES & UNIVERSITIES, WASHINGTON, D.C.

Mr. **Bratton**. Senator Dole and members of the Finance Committee:

I am Dan Bratton, and I'm the president of Kansas Wesleyan College in Salina, Kans., but I am here on behalf of the National Association of Independent Colleges & Universities, the American Council on Education, as well as 10 other higher education associations, which together represent over 2,000 public and private colleges and universities.

Obviously, within the time available, I cannot refer to the specifics of S. 1564 nor to the specifics of a statement bearing my name delivered here yesterday. Instead I will just make these very brief general points:

One, we support any legislation which eliminates unwholesome and inappropriate uses of tax law by tax-exempt entities.

Two, we do not ask for an exclusion from the bill.

Three, we feel that the statement can be made that a distinction can be made between arrangements for leasing facilities back that would serve no purpose other than to generate some tax savings and those which truly facilitate institutional growth and development, that there are honorable leases in the current law.

Four, in particular colleges contain some of the finest historical buildings in America which need rehabilitation, which will not receive it if left solely to the resources of a given institution if current law is amended. They will be torn down, and society will be the poorer for it.

Five, according to our analysis of the proposed legislation, it may well result in some well-intended concerns affecting some unintended and damaging results. In short, Senator, we must guard against throwing out the proverbial baby with the proverbial bath water.

Senator, these are challenging days, probably the most challenging days higher education has known in 50 years.

As I have indicated on this issue, in my 10 years as a college president, with my senior Senator from Kansas, I have been struck by our common opinion that Federal role must go beyond the level simply of direct dollar support; there must also be an appropriate encouragement and facilitation by government of the private sector, working with individual initiative, and we feel that some aspects of sale leaseback permit this. We realize that some are inappropriate, and we stand to work with you to discover what those are and draft the appropriate legislation.

The **Chairman**. Mr. Hooker?

[Mr. Bratton's prepared statement follows:]

Testimony to the Committee on Finance
U.S. Senate

on

S. 1564, The Governmental Lease Financing Reform Act of 1983

Presented by

Daniel L. Bratton
President
Kansas Wesleyan College

on behalf of

American Association of Community and Junior Colleges
American Association of State Colleges and Universities
Association of American Universities
American Council on Education
Association of Catholic Colleges and Universities
Association of Governing Boards of Universities and Colleges
Association of Jesuit Colleges and Universities
Council of Independent Colleges
National Association of College and University Business Officers
National Association of Independent Colleges and Universities
National Association of Schools and Colleges of United Methodist Church
National Association of State Universities and Land-Grant Colleges

July 19, 1983

The National Association of Independent Colleges and Universities (NAICU), the American Council on Education (ACE), and the other higher education associations listed on the front page of this testimony, together represent more than 2000 public and independent colleges and universities across the country. The memberships of these associations include institutions of higher education whose variety in size, control, and mission exemplify the rich diversity of both the public and independent non-profit sector.

In recent years, colleges and universities have experienced financial problems. Cyclical enrollment declines, increased costs, and declining federal support have combined to create fiscal difficulties for many institutions of higher education. In an effort to keep their financial situation on a steady course, colleges have attempted to develop appropriate new methods of financing higher education and of reducing operating costs. Colleges view these measures as necessary to fulfill their responsibility to ensure continued access and choice for those who wish to pursue higher education.

Historically, the federal government has assisted higher education through direct grant and loan programs, and also has recognized the public purpose activities of colleges and universities through the tax code. Although indirect, this latter recognition -- specifically in the form of exemption from federal income taxation and deductibility for charitable contributions -- has perhaps been as important as direct programs. In providing both direct and indirect recognition, Congress has evidenced its belief that institutions of higher education serve an important public purpose.

That purpose, it is important to note, has economic as well as social dimensions. America's colleges and universities provide not only a more enlightened citizenry, vital though that function is; they also train America's managers, engineers, technicians, scientists, artists, skilled labor, and other professionals; conduct much of America's basic and applied research; and are the source of much of the creativity necessary to economic growth. In short, even though colleges and universities are not in the narrow sense taxable, profit-making enterprises, the "investment in human capital" represented by funds made available to these institutions ultimately does generate economic growth and, thus, tax revenues. In addition, colleges and universities serve as one of the largest, if not the largest, employers in many communities, thus generating further economic growth.

Accordingly, the higher education community would express disagreement with the general proposition that tax incentives intended to encourage investment or otherwise stimulate economic growth should not be utilized in a manner benefiting colleges and universities.

The higher education community recognizes, however, that instances may exist in which transactions that are beneficial to colleges and universities may, nonetheless, be viewed as inconsistent with sound tax policy. The provisions of S. 1564 affecting tax-exempt organizations such as colleges and universities appear to be motivated by a concern that specific transactions engaged in or under consideration by particular institutions may fall into this category. Thus, in introducing S. 1564 on June 29, 1983, Senator Dole noted several examples of transactions which he believes to be undesirable. The examples include the Navy's leasing of support ships, a college's proposed sale and leaseback of "its entire campus," and a city's leasing of its entire electric power plant. While higher education associations are sympathetic to the financial problems that make transactions of this sort attractive to educational institutions as well as local governments, we find it difficult to disagree that sales and leasebacks of existing buildings should be curbed where the transaction serves no purpose other than the generation of tax savings shared in part with the institution. Such transactions may produce additional dollars for the exempt institution, but they do not directly further its productive function. Nor do they necessarily further the Congressional purpose that was evident in enactment of the accelerated cost recovery system (ACRS) of augmenting the nation's stock of capital assets.

One provision of S. 1564 shows an understanding of the difficulties faced by colleges and universities, in obtaining the use of computers and other high technology equipment with a relatively short useful life. The House version of this bill (H.R. 3110, as introduced by Rep. J.J. Pickle) requires straight-line depreciation over 12 years. In contrast, the Senate bill provides that if property has a class life under the ADR system of 6 years or less and is leased for a term not in excess of 75% of that life, the property is generally exempt from the bill. Although these restrictions may still result in increases in the cost of leasing some equipment subject to risks of rapid obsolescence, we appreciate Senator Dole's favorable recognition of the high technology equipment needs of colleges and universities, and we are grateful for this change from the House version.

Senator Dole, in his introduction of the bill, stated "our preliminary analysis shows that ACRS provides no greater benefit than economic depreciation" and that "indeed, ACRS depreciation is slower than that allowed under prior law." Under prior law, a lessor could have, for example, depreciated a computer over a 5-year period using accelerated methods of depreciation. At this time, we are uncertain of the impact of

S. 1564 on high technology property leased to higher education institutions. We ask that we be allowed to work with the Committee in arriving at a reasonable method and term of depreciation to assure that there will not be a devastating effect on the use of high technology equipment by educational institutions.

As for the remainder of the bill, we believe that as presently drafted, S. 1564 would penalize higher education institutions engaging in transactions that are qualitatively different from those prompting this proposed legislation.

With respect to real property used by a tax-exempt entity, S. 1564 would require straight-line depreciation over the greater of 40 years or 125 percent of the lease term, rather than ACRS over 15 years. Real property is treated as "used" by a tax-exempt entity, and thus these provisions may apply, if: 1) the property is financed in whole or in part with tax-exempt bonds and the institution or a "related entity" participated in the financing; 2) it is leased to an institution under an agreement containing a fixed-price purchase or sale option which involves a tax-exempt or related entity; 3) the institution sells or leases the property and then leases it back; or 4) the lease involves a term of greater than 10 years. These provisions would not apply, however, unless more than 50 percent of the use of the property consisted of use by the institution. (The bill does not specify how such "use" is to be measured.) A separate provision of the bill would disallow the rehabilitation tax credit for any portion of an expenditure for rehabilitation of a building to be used (under the tests noted above), or reasonably expected to be so used, by a tax-exempt entity.

In the brief period that has elapsed since the introduction of S. 1564, the higher education community has not been able to develop complete information as to the potential impact of these complex and somewhat ambiguous provisions on their more than 2000 member institutions. Based on the limited information available, however, it appears that the bill would adversely affect certain types of worthwhile transactions illustrated by the following examples:

1. The medical school of University A and its teaching hospital use various types of sophisticated diagnostic and treatment equipment. The university's graduate school departments (e.g. chemistry, biology, and physics) also make substantial use of high technology research equipment. Because such equipment is likely to become technologically obsolete within four to six years, the university frequently leases it rather than purchase it. The ADR class life of the equipment, however, is generally nine years. The S. 1564 exception for "short lived property" would, therefore, not be available. A three-year lease would appear to be permitted under the "short-term lease" exception, but in many cases, University A may wish to use a somewhat longer lease, or assure its continued access to the equipment (should that prove desirable) through a limited renewal option. Under S. 1564 as presently drafted, it would be able to do so only at the price of substantially increased rentals.

2. College B has an administration building, parts of which are 40 years old and parts of which are 60 years old. The building is in need of rehabilitation at a cost of $3.4 million. By entering into a proposed sale and leaseback transaction with a taxable corporation which would utilize the rehabilitation credit and ACRS deductions, the college would reduce this cost by an estimated $350,000. The 40-year straight-line recovery period and the inability to utilize the rehabilitation credit, which would result from S. 1564, would have a substantial adverse impact on this transaction since the financing would no longer be feasible.

3. College C, an urban university, has several high-rise dormitories which it proposes to sell to a limited partnership. The limited partnership will substantially renovate the buildings and lease them back to College C at fair rental value. This transaction is clearly adversely affected by S. 1564, and would not go forward if the bill is enacted.

4. In order to accommodate a projected peak in cyclical enrollment, College D, a state university, proposes to lease student housing to be constructed by a taxable corporation. The lease will be at fair rental value and provide for a 10-year initial term with two 5-year renewal options. The university will have no fixed-price purchase option and will not indemnify the corporation against losses. The housing could be converted by the corporation to an apartment complex at the end of the lease term. S. 1564 would have a substantial adverse impact on this transaction.

Unlike the examples cited in support of S. 1564, each transaction of the sort described above involves a new expenditure of funds for a capital asset. The higher education community believes that in these circumstances the capital formation purposes underlying ACRS are served. Moreover, the new construction or rehabilitation expenditures involved in these transactions directly produce taxable revenues. The capital assets themselves, by furthering the institution's performance of its economic role, should ultimately enhance economic growth. Finally, it should be noted that in one respect, leases to tax-exempt entities have a more favorable impact on federal revenues than do leases to taxable entities. In a lease to a taxable entity, the rental income to the lessor produces a corresponding rental deduction to the lessee. Where the lessee is tax-exempt, however, the lessor has rental income but the rental deduction produces no additional revenue loss. S. 1564, however, generally fails to distinguish productive transactions from unproductive ones.

One striking example of S. 1564's failure to draw appropriate distinctions is its treatment of older college buildings sold to a private developer at fair market value, renovated by the developer, and then leased back to the college at a fair rental value. In the Economic Recovery Tax Act (ERTA) of 1981, Congress specifically provided that the increased credit for "qualified rehabilitation expenditures" on older buildings and historic structures should be available, to the extent of basis attributable to such expenditures, with respect to properties used by tax-exempt entities. In doing so, Congress recognized that application of the general disallowance of "the investment credit for property leased to tax-exempt organizations and governments [would] operate to significantly impair Congressional intent to encourage the rehabilitation of older structures." */ Thus, in ERTA, Congress correctly recognized that the public policy favoring rehabilitation of older and historic buildings is served in equal measure whether the buildings are used by tax-exempt or taxable entities.

S. 1564, however, runs completely counter to the policy recognized in ERTA. The only manner in which the rehabilitation credit can be utilized to encourage renovation of older and historic properties owned and used by colleges and universities is through a sale to a taxable entity, rehabilitation by the entity, and a subsequent leaseback of the properties.

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*/ Report of the House Committee on Ways and Means on H.R. 7956, the Miscellaneous Revenue Act of 1980, September 4, 1980, p. 21. H.R. 7956 contained the rehabilitation expenditure changes ultimately adopted in ERTA.

As presently drafted, S. 1564 would both require use of the straight-line method of depreciation over at least a 40-year period, rather than under ACRS over 15 years, and (unlike the House bill) deny altogether the credit for qualified rehabilitation expenditures. This result is produced by the bill's inclusion of all sales and leasebacks, without regard to their economic substance or objectives, within the definition of "tax-exempt use" real property, and its denial of the rehabilitation credit for tax-exempt use property. Denying either ACRS benefits or the rehabilitation tax credit with respect to tax-exempt entities is, we submit, plainly unjustified and contrary to the ERTA policy of making rehabilitation incentives equally available to property used by tax-exempt organizations. A denial of both would most assuredly have the effect of stopping virtually all rehabilitation of older ot historic buildings owned by colleges and universities. Denial of the rehabilitation credit is an especially harmful restriction. Without ACRS or the rehabilitation credit, rehabilitation of colleges buildings will no longer be attractive to investors. Most colleges cannot afford the costs of rehabilitation themselves. Thus, many of the older but very important campus buildings which colleges intended to rehabilitate through the sale-leaseback will, if this bill becomes law, remain dormant or be torn down complately.

The bill's proposed denial of ACRS and the rehabilitation credit for expenditures made to preserve and restore older or historic properties currently owned by colleges and universities cannot fairly be characterized as correction of an abuse. Rather, it is a proposal to reverse tax treatment that Congress two years ago declared was necessary in order to provide equal incentives for rehabilitation. We submit that the prior decision was correct, and should not be reversed at this time.

To summarize, the higher education community believes that economically productive transactions logically can and should be distinguished from the sterile transactions, in and of themselves, productive of nothing but tax benefits, motivating the provisions of S. 1564 applicable to colleges and universities. If, for example, the tax benefits that S. 1564 proposes to disallow were, in the case of colleges and universities, allowed only with respect to new property or, for substantial rehabilitation to the extent of the rehabilitation expenditures, then both the transactions perceived as abusive and any threat to tax revenues posed by potential sale and leasebacks of the existing stock of college and university property would be eliminated.

In closing, the higher education community wishes to emphasize that our limited analysis of this proposed legislation and its potential effects leaves us with great concern. Neither colleges and universities, nor the Administration, nor the members of Congress have had time to make an adequate assessment of its potential impacts. In considering this legislation, Congress is discussing substantial changes in current law. We ask that Congress take its time in order to ensure that all those involved are treated fairly and in good faith. We believe that a solution to the problems raised by these transactions must be carefully crafted to avoid unnecessary and unsound impacts on legitimate, traditional transactions engaged in by colleges and universities, and other tax-exempt organizations. If immediate legislative action is viewed as necessary, it should be narrowly targeted at unproductive, purely tax-motivated transactions. We should leave for more careful consideration the desirability of further restricting generally available tax benefits simply because a tax-exempt organization uses property to which those benefits relate.

STATEMENT OF MICHAEL HOOKER, PRESIDENT, BENNINGTON COLLEGE, BENNINGTON, VT.

Mr. HOOKER. Mr. Chairman, small liberal arts colleges are an essential component of higher education in this country, but many of them are in severe financial difficulty.

During the decade of the sixties, colleges developed their faculties and their facilities in order to meet the baby boom at that time. The baby boom needs were met, and colleges are now left with certain fixed costs incurred during the period of expansion. Unless some method can be found for them to convert their major financial asset, that is, equity in their buildings, into operating capital, many such colleges will close during the next decade.

Sale-leaseback enables the conversion of property to working capital, and it is exactly the method that would be used by any small undercapitalized company to sustain itself financially. It is the kind of transaction that Bennington has been structuring for the past year.

I respectfully request that an exemption be made in S. 1564 for our small liberal arts colleges which are in such financial difficulty at present.

The CHAIRMAN. Mr. Oosterhuis.

[Mr. Hooker's financial statement follows:]

TESTIMONY OF MICHAEL HOOKER, PRESIDENT OF BENNINGTON COLLEGE, BEFORE THE SENATE FINANCE COMMITTEE ON S.1564, JULY 19, 1983

Ladies and Gentlemen:

S.1564 addresses the problem of off-budget financing and to that extent I am fully supportive of its intent. However, in my judgment, the greater public good would be served by excluding higher education from the effect of the bill.

Higher education is in financial difficulty, and those difficulties are going to become far more severe in the near future. Colleges are faced with a twenty percent decline in enrollment in the next decade and proportionately lower tuition revenues. It is not possible to respond simply by cutting costs. During the decade of the sixties, when the "baby boom" cohort was passing through college, higher education responded to the enormously increased demand on its services by expanding its facilities and faculties. That expansion, which was done partly in response to public pressure and to pressure from Congress, resulted in certain "fixed costs," which remain even in these times of decreasing enrollment and escalating costs.

Colleges are scrambling to meet costs, and my college, Bennington, serves as emblematic of the difficulties they face. In order to fund escalating operating deficits, Bennington for the last twelve months, has been structuring a lease-leaseback transaction which would enable it to pay off short-term, high interest debt and to realize operating capital over the next five years. I understand that a number of other higher education institutions are considering doing the same thing.

It is important, in considering S.1564, to recognize a difference between colleges on the one hand and governmental agencies on the other. The Internal Revenue Code has, since 1917, been constructed so as to support higher education. That support comes through charitable contribution deductions, and more recently through the use of tax exempt bond financing of college construction and student financial aid. From a fundamental philosophical point of view - that of serving the public good represented by higher education through the use of tax law - I see no difference between the use of sale-leaseback financing and charitable giving.

If, however, there is in the view of the Committee a substantial difference where I see none, then at least those business transactions available to private enterprise should also be available to independent colleges and universities. It is ironic that a college could not benefit through reduced costs by selling its building to investors and leasing it back, but any business that owned its own building could so benefit. In neither case is the tax status of the institution relevant to the financial structure or attractiveness of the transaction.

This Committee and its colleagues in Congress have periodically revised tax laws to give tax breaks to individuals in order to stimulate investment in enterprises that are deemed to be in the national interest. Among such enterprises have been real estate development, oil and gas exploration, low-income housing, agricultural development, and a host of others. While it was not the intent of Congress to support higher education through laws governing real estate depreciation, it is a fortuitous result of tax law that colleges can so greatly benefit without the infusion of massive federal aid.

Whereas now tax-sheltered private investment is going to support the purchase and syndication for sale of already existing office buildings, shopping centers and apartment complexes, it is surely in the greater national interest that our colleges remain strong. It would be shortsighted not to look to the uses to be made of money generated through sale-leaseback transactions and to ask whether those uses are indeed in the national interest. If the answer is yes, as it is in the case of higher education, and if Congress doesn't permit colleges the use of sale-leaseback financing, then we risk the future of this Nation by insuring that institutions of higher education will decline in quality.

STATEMENT OF PAUL W. OOSTERHUIS, ESQ., HOGAN & HARTSON, WASHINGTON, D.C., ON BEHALF OF THE COMPUTER & BUSINESS EQUIPMENT MANUFACTURERS ASSOCIATION, WASHINGTON, D.C.

Mr. OOSTERHUIS. The Computer Equipment Manufacturers Association believes that S. 1564 takes the correct approach to the problem of leasing by tax-exempt entities by excluding short-lived equipment from its ACRS-related provisions.

For short-lived equipment such as computers, copiers, and other similar office equipment, ACRS did not provide any increase in tax benefits over prior law; indeed it reduced the tax benefits associated with that equipment. ACRS, in fact, provides for depreciation which is even slightly slower than that taken by most publicly held companies for book financial purposes; thus, it cannot be said that any significant abuse potential exists with respect to the lease of computers, copiers, and other similar business equipment to tax-exempt entities.

However, S. 1564 as introduced contains a definition of equipment to be treated as short-lived property, which we believe is too narrow. The bill provides that property which is otherwise short lived—that is, property which has an ADR midpoint of 6 years or less—will not be treated as short lived if it is subject to a lease which extends for a period longer than 75 percent of the property's ADR life. Under this provision computers and other similar office equipment with a 6-year ADR life would be treated as short-lived property only if they are subject to leases of 4.5 years or less. While copiers have lease periods that are shorter than that, many computers are subject to leases of 5 years, and in a few cases 6 years. Thus, under this provision, computers leases would not be treated as leases of short-lived property and therefore exempt from the bill.

We believe this result is not justified for a number of reasons. Most importantly, the longer length computer leases of computer manufacturers are so-called operating leases. The lessor has the obligation to repair or replace defective or wornout equipment and parts, and the lessor grants to the lessee the right to up-grade equipment during the lease term as new lines of equipment are introduced by the manufacturer.

Given these provisions, the term of the lease itself is not an indication of the useful life of the property subject to the lease at the beginning of the lease term; rather, the term of the lease merely indicates the period of time over which the lessor is willing to commit that he will provide a fully functioning computer system.

For these reasons we believe that S. 1564, as introduced, should be amended to permit all property with a present ADR class life of 6 years or less to be excluded from its provisions without regard to the lease term of that property.

The CHAIRMAN. Mr. Alexander?

[The prepared statement of Mr. Oosterhuis follows:]

WRITTEN STATEMENT OF PAUL W. OOSTERHUIS ON BEHALF OF THE COMPUTER & BUSINESS EQUIPMENT MANUFACTURERS ASSOCIATION

Statement

My name is Paul W. Oosterhuis. I am a partner in the Washington law firm of Hogan & Hartson. I am appearing today on behalf of the Computer and Business Equipment Manufacturers Association ("CBEMA"), an association composed of approximately 42 manufacturers of computer systems, sophisticated business equipment and other high technology electronics products. I appreciate this opportunity to appear before the Finance Committee to discuss S. 1564.

The bill as introduced would have a major impact on those CBEMA members which in the ordinary course of their business lease computers, copiers, and other business equipment to federal, state, or local governments, hospitals, educational and charitable institutions, and other tax-exempt entities. The bill would also have an identical impact in the much more limited situation where CBEMA members lease computers, copiers and other similar equipment to foreign users.*/

S. 1564 was introduced to remedy problems perceived to exist in connection with the availability of ACRS and in some cases the investment credit for property leased to governments and other tax-exempt entities. The apparent concern is that under some circumstances ACRS provides an incentive for tax-exempt entities to lease rather than purchase equipment and real property. S. 1564 attempts to eliminate this concern primarily by increasing the time period over which the costs of such equipment can be recovered.*/ Under the bill, equipment costs which presently can be recovered over five years on a slightly accelerated basis under ACRS would be required to be recovered on a straight-line basis over the longer of (i) the present asset depreciation range (ADR) system class life for the equipment, or (ii) 125% of the term of the lease (including any optional renewal or extension periods). The bill applies to all equipment which is ACRS recovery property and is used by tax-exempt entities unless the property qualifies as "short-lived property" or is used pursuant to a "short-term lease."

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*/ However, any expansion of the bill to leases by foreign subsidiaries of CBEMA members to foreign users would have a substantial adverse impact. Indeed, the impact would be so substantial that it would outweigh by a considerable margin the impact of all other provisions of the bill taken together.

The present ADR class midpoint life for computers, data processing, copying and other similar equipment manufactured by CBEMA members is six years. See Asset Guideline Classes 00.12 and 00.13, Revenue Procedure 77-10, 77-1 C.B. 568. Lease terms for computers, copiers, and similar business equipment range anywhere from one to five or six years in length. Although no thorough study is available, it appears that the most frequently used lease term for computers is five years.[*/] Under S. 1564, the cost of a computer leased to a U.S. tax-exempt entity under a typical five-year lease would be recovered over six and one-fourth years on a straight-line basis, rather than over five years on an accelerated basis as currently provided under ACRS. Thus, unless the exception for "short-term leases" or for "short-lived property" applies, the bill as introduced would affect all computers and other similar equipment leased to tax-exempt entities.

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*/ The bill also denies the investment credit for leases of certain equipment to foreign governments and speaks generally to the issue of when an arrangement constitutes a lease versus a service contract for investment credit purposes. These two changes are of less importance to CBEMA members and are not discussed herein.

Under the bill, "short-term leases" are defined as leases for a term less than the greater or (i) one year, or (ii) 30 percent of the present ADR class life but not more than three years. As indicated above, the leases commonly used for computers and similar business equipment are for terms of about five years. Moreover, most shorter-term leases grant the lessee an option to extend the lease term for a period which would total about five years. Given these typical lease terms and the present ADR class life for computers of six years (meaning that a "short-term lease" could in any event not be for a term of more than 1.8 years), this exception would not generally be applicable to computers, copiers, and similar business equipment.

S. 1564 also contains an exception for so-called "short-lived property." "Short-lived property" would include property

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[*/] The most frequently used lease term for copiers appears to be two years.

with a present ADR class life of six years or less but only if the term of the lease to which the property is subject is 75 percent or less of that class life. Under this rule, property with an ADR class life of six years would be "short-lived property" only if subject to a lease term of 4.5 years or less. Thus, while copiers would normally qualify as "short-lived property" under this rule, computers and other similar business equipment in many cases would not qualify for the exception unless lessors were to change their current business practices significantly to provide for shorter lease terms.

We believe that S. 1564 takes the right approach to the problem of leasing to tax-exempt entities by excluding short-lived equipment and thereby limiting the application of the bill to the kinds of property with respect to which the enactment of ACRS established a substantial incentive to lease: real estate and equipment with useful lives substantially in excess of five years. Because the useful life of computers, copiers, and other business equipment is in fact relatively short, the enactment of ACRS did not, contrary to popular perception, give rise to new tax benefits with respect to such equipment. As is discussed above, the ADR system, under which equipment could be depreciated prior to the advent of ACRS, established a six-year midpoint life for computers, data processing, copying, and other similar equipment. In this ADR class equipment could be depreciated over five, six or seven years without challenge. The equipment could also be depreciated over a shorter period if the facts and circumstances justified such treatment. In all cases the double-declining balance method could be used. Under ADR many taxpayers did depreciate their computers and other similar equipment over five years.*/ Other taxpayers depreciated their computers and similar equipment over a four or even a three-year period based on their particular facts and circumstances.

These depreciation methods used for tax purposes under ADR were consistent with the methods and lives which have been and continue to be used by companies for financial reporting purposes. While some companies establish a different life for mainframe processing equipment and peripherals (discussed in more detail below), on average most computer equipment is depreciated for book purposes over five or fewer years on an accelerated basis. Thus, ADR depreciation for tax purposes was no more generous than the depreciation which has been and is now provided generally for financial purposes. At best ADR tended to reflect the true economic depreciation of computers and other similar equipment.

Because under ADR taxpayers could and did depreciate computers and other similar business equipment over five or fewer years utilizing a double declining balance method, the enactment of ACRS cost recovery (without regard to the investment credit changes in either the 1981 or 1982 Acts) gave rise not to an increase but to a decrease in the level of tax benefits available to computer owners. The table below shows, at various relevant discount rates, the present value of tax benefits available under ACRS and under ADR for taxpayers which were depreciating equipment over five years utilizing the double-declining balance method:

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*/ Although some taxpayers chose to depreciate equipment over seven years, they did so primarily to obtain a larger investment credit (10 percent rather than 6.67 percent).

Comparison of
Present Value of ADR and ACRS
(For Property Depreciated Over 5 Years
Under ADR and ACRS)

Discount Rate	ADR	ACRS
0	46.00	46.00
6	40.59	39.64
8	39.04	37.83
10	37.61	36.18
12	36.26	34.63
14	35.00	33.20

The above table illustrates that at all relevant discount rates, the change from ADR to ACRS did not give rise to any new tax benefits which could create a potential for abuse involving the lease of computers or other similar business equipment to tax-exempt entities. Indeed, the change in fact reduced the tax benefits for such equipment.

Moreover, leasing has traditionally been offered to all customers by computer manufacturers as an alternative to purchase not because of tax benefits, but because many customers (including tax-exempt entities) prefer leasing for several business reasons unrelated to tax benefits. For example, by leasing rather than purchasing equipment, a user can effectively shift the risk relating to the value of the equipment at the end of the lease term (the so-called "residual value") to the lessor. Similarly, in many so-called operating leases customers can shift to the lessor the risks that equipment will wear out or become outmoded during the lease term. Through these means users can avoid the risk that during or at the end of the lease term they will be using technologically obsolete equipment. This result is obviously important to many users since computers and similar business equipment involve rapidly evolving technology. In addition, leasing in effect provides users with 100 percent financing of the leased equipment, often at relatively favorable rates (compared to taxable debt financing). Thus, whether the user is a taxable or tax-exempt entity and regardless of the tax treatment involved, leasing computer equipment is preferable to owning for many users.

For these reasons, we support the approach of S. 1564 in excluding short-lived equipment from its provisions relating to ACRS. However, we believe that the "short-lived property" exclusion should not be limited to property subject to a lease which (including any extensions) has a term 75 percent or less of the property's ADR class life. This limitation is presumably based on the concept that the lease term for equipment provides a sound basis for determining the useful life of that equipment. This concept as applied to most longer-term computer leases of CBEMA members is fundamentally flawed.

Most longer-term leases offered by computer manufacturers are so-called "operating leases," under which the lessor has an obligation to maintain, repair and replace any and all equipment during the lease term. Where such leases involve large mainframe computers (the primary computers subject to relatively long leases), the mainframe processing equipment itself may well function properly for six or seven years without becoming too technologically obsolete for continuing use. However, the key parts of the peripherals of the system (terminals, printers, scanners, etc.), which today typically make up one-half of the total cost of a large computer system, will generally wear out or become obsolete in a much shorter period of time, often three or four years. Thus, if a computer manufacturer enters into a five or even a six-year operating lease of a computer system, that company takes on the responsibility and cost of replacing peripherals which it knows will wear out before the end of the lease term.*/

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*/ It is for this reason that for financial purposes, companies which manufacture and lease the largest computer systems tend to use separate useful lives for mainframes (generally six years on an accelerated basis) than for peripherals (three or four years on an accelerated basis).

Moreover, typically in longer-term operating leases, computer companies as lessors permit lessees to upgrade individual items of equipment (particularly peripherals) as new generations of equipment are placed on the market by the lessor company. An equipment upgrade during a lease term can most often be accomplished without any increase in lease payments, since the typical pattern in the computer industry is that the next generation of products is not priced any higher when introduced than was the preceding generation of products when introduced.

In leases where the lessor is obligated to replace equipment and parts that are worn out during the lease term and where the lessee has the right to upgrade equipment during the lease term, the total lease term relating to the overall computer system does not give a good indication of the useful life of any of the leased property. It merely states the period of time over which the lessor commits to assuring the lessee of having a fully functioning computer system. Thus, at least with respect to computers, the term of any lease cannot logically be used as a test of whether or not the property is in fact "short-lived property" which should be excluded from the provisions of S. 1564. For this reason we strongly urge that the definition of "short-lived property" be modified to eliminate the limitation based on the term of any equipment lease.

The level of tax benefits of short-lived equipment such as computers and other business equipment was decreased, not increased, under ACRS. This level of depreciation at best does no more than reflect actual economic depreciation. For this reason and because leases of computer equipment have traditionally existed for non-tax reasons, we believe that any provisions adopted by the Finance Committee to eliminate any incentive established in ACRS for tax-exempt entities to lease rather than own equipment should exclude short-lived equipment generally without regard to the term for which such property is leased. This result can be accomplished simply and easily by amending the definition of "short-lived property" in the bill as introduced to eliminate the limitation based on 75 percent of the ADR class of the property.

A complete exclusion of short-lived equipment from the modifications to ACRS in S. 1564 would not in any way detract from the overall goals intended to be accomplished by the legislation. It would merely prevent that legislation from unnecessarily penalizing owners of short-lived equipment which lease to tax-exempt entities.

STATEMENT OF DONALD C. ALEXANDER, OF MORGAN, LEWIS & BOCKIUS, ON BEHALF OF THE CHAMBER OF COMMERCE OF THE UNITED STATES, ACCOMPANIED BY DAVID FRANASIAK

Mr. **Alexander**. Mr. Chairman, on behalf of the U.S. Chamber, we endorse the testimony of the previous witness in discussing short-lived property.

With me, by the way, is David Franasiak, who is the manager of the chamber's tax policy center.

There are two other points I wish to make very briefly, Mr. Chairman. One is that foreign-used U.S.-manufactured property should, as the Assistant Secretary pointed out this morning, be exempt from this bill.

What we are talking about here is jobs. We are talking about U.S. exports competing with foreign-subsidized exports.

A member of this committee, Senator Heinz, has just reported, at the Banking Committee, S. 869. The report of S. 869 points out that the means we have now of promoting exports is insufficient. We shall not make further reductions in our ability to compete.

Finally, Mr. Chairman, the transitional rules in this bill are very harsh and should be modified to apply to transactions only if there were no binding contract on either side.

[The prepared statement follows:]

STATEMENT
on
GOVERNMENTAL LEASE FINANCING REFORM ACT OF 1983 (S. 1564)
before the
SENATE FINANCE COMMITTEE
for the
CHAMBER OF COMMERCE OF THE UNITED STATES
by
Donald C. Alexander
July 19, 1983

My name is Donald C. Alexander. I am a member of the Taxation Committee of the Chamber of Commerce of the United States, for whom I am appearing today. I am a member of the law firm of Morgan, Lewis & Bockius, of Washington, D.C. I am accompanied today by David E. Franasiak, Manager of the Chamber's Tax Policy Center. On behalf of the U.S. Chamber, I appreciate this opportunity to express our views on S. 1564.

Although we do not fundamentally disagree with the intent of the legislation, S. 1564 as introduced is overly broad. The bill, according to Senator Dole's statement of June 29, is designed to "prevent the enormous end run on the Federal Treasury that has been attempted through the use of long-term tax-exempt lease financing". The bill was prompted by the Navy's attempt to lease TAKX ships and proposals to sell and lease back public buildings and college campuses. However, the bill goes far beyond such activities.

If enacted in its present form, it would have a major adverse impact on our members who manufacture computers, diagnostic equipment and other short-lived assets, as well as manufacturers of telecommunication, aerospace and other equipment who must compete internationally. We urge the Committee to narrow the scope of the legislation in order to directly and discretely address the perceived abuses.

High Technology Short-Lived Assets

The proponents of S. 1564 are rightly concerned that under present law there may be an incentive for a tax-exempt entity to lease, rather than own, equipment. Under certain conditions, cost recovery allowances may be received well in advance of associated costs (such as loan service payments); the resulting substantial deferral of tax to the lessor creates an incentive to enter into transactions like those described in the press.

However, this problem does not occur in the case of computers and certain diagnostic equipment which have very short economic lives. Technology in these areas changes at a rapid pace. Today's state-of-the-art equipment quickly becomes technologically and economically obsolete. Prior to the Economic Recovery Tax Act of 1981 (ERTA), this type of asset had a class life at the lower limit of the Asset Depreciation Range (ADR) of five years and could be depreciated using the double declining balance method. In adopting the Accelerated Cost Recovery System (ACRS), Congress did not shorten the recovery period for these assets, but instead substituted the 150 percent declining balance method for the double declining balance method. Clearly, lessors of short-lived equipment do not receive unwarranted tax deferral under ACRS; indeed, the present values of the tax benefits available to lessors under ACRS are less than the benefits of ADR under prior law.

S. 1564, although an improvement as compared with H.R. 3110 pending before the House Ways and Means Committee, would further reduce the present values available to lessors under current law. Under S. 1564, tangible personal property generally must be depreciated using the straight-line method over the present class life of the property or 125 percent of the lease term, whichever is greater. An exception is made for short-lived assets with a "present class life" of no more than six years if the lease term does not exceed 75 percent of such present class life. The effect of S. 1564 is to deny ACRS for short-lived, high-technology equipment if the lease term is more than 4.5 years. Such equipment with a six-year midpoint class life is to be depreciated ratably over such period provided the lease term is no more than five years.

While the above alternative is superior to that in H.R. 3110, it is still defective. Since there is no deferral of income in this situation, we urge the Committee to exempt property where the ACRS life approximates the class life under ADR.

Governmental and other tax-exempt entities cannot, in any way, benefit from a law which requires lessors to depreciate short-lived, high technology property over longer periods or by the use of slower methods than are allowed under ACRS. The total cost of the asset will simply increase, and the result would be a higher cost to the tax-exempt entity with no savings to Treasury. The only viable choice would be for the tax-exempt entity to pay this higher cost for the equipment and take the chance that the equipment will not be obsolete in 24 or 36 months. Many tax-exempt entities and governmental bodies would find it necessary to delay or forego purchases of needed computer, medical or diagnostic equipment if the proposed legislation is adopted.

Foreign Lessees

Under current law, most property used predominantly outside the United States is not entitled to the investment tax credit, but the ADR midpoint class life and the double declining balance method may be used for depreciation purposes. However, specified transportation and communication equipment having contact with the United States, including commercial aircraft, ships, railroad rolling stock, motor vehicles, containers, oil service and communications equipment, is entitled to the investment tax credit and ACRS cost recovery.

With respect to property used predominantly outside the United States by foreign persons, S. 1564 would totally eliminate the investment tax credit and generally require use of the ADR midpoint class life and the straight line method for depreciation purposes. The short-lived property exception would allow the use of the current depreciation rules for property with a class life of six years or less where the lease term did not exceed 4.5 years, but all longer-lived property would be denied both the investment tax credit and the benefits of accelerated depreciation.

Many economic and trade issues are presented by this section of the bill. We agree with Treasury's position, as enunciated before the House Ways and Means Committee on H.R. 3110, that this section of the bill should be withdrawn for further study. Enactment of this provision would have grave unintended results, including but not limited to the diminished ability of our domestic manufacturers in the aerospace, oil services, transportation, and telecommunication industries to compete abroad.

Exports of United States manufactured goods would be jeopardized by this bill. This would come at a time when our overall balance of trade is negative, and our export industries are striving to overcome the effects of a strong dollar and increased foreign competition in all of our key industries. The International Trade Commission estimates that the total value of equipment on lease by U.S. firms in 1981 was about $46 billion, and the U. S. equipment leasing services industry produced a favorable trade balance of over $10 billion in 1981. Striking out whatever incentives exist in present tax laws and substituting disincentives would likely eliminate one of the few areas in which our trade balance is favorable and would make U.S. products less able to compete against subsidized foreign goods.

Domestic companies that compete in worldwide markets would be seriously disadvantaged. Frequently a domestic manufacturer is required to provide financing. The bill would effectively eliminate leasing as a viable financing alternative. Even if alternative sources of financing are available, the sale may be lost because the price of the product would by necessity increase. The result is lost market share, lost exports and fewer domestic jobs. The bill would also disrupt routine financing arrangements between U.S. parent corporations and their foreign subsidiaries or branches, thus interfering with the ability of U.S. multinationals to compete with their foreign rivals.

The change made in the House definition of tax-exempt entity with respect to foreign persons is a step in the right direction but by no means solves the problem. For example, as the Treasury pointed out in its testimony before the House, tax treaties, such as those relating to the operation of shipping and aircraft, exempt revenues otherwise subject to U.S. tax. This exemption would prevent a foreign airline from qualifying under proposed section 168(i)(13)(E)(iii). As the Treasury pointed out, the effect "would be harsher if the user is from a country with which we have a tax treaty than if he is from a country with which we have no treaty, an anomalous result."

In recommending that the foreign user portion of the bill be withdrawn for further study, we question whether distinctions should be drawn between U.S.-produced and foreign-produced goods. To differentiate between U.S.-produced and foreign-produced goods might well raise discrimination questions under GATT and other trade policy issues that have not yet been addressed. Believing that the present rules with respect to foreign-use property do not provide special tax incentives, we do not understand why U.S. lessors should be placed at a competitive disadvantage with respect to foreign financial institutions financing such property.

Effective Date

S. 1564 would apply to all property placed in service by the taxpayer after May 23, 1983, the day prior to that on which H.R. 3110 was introduced. A narrow exception applies to property used pursuant to written binding contracts in existence on May 23, 1983 which required (i) the lessor to acquire, construct, reconstruct or rehabilitate the property and (ii) the tax-exempt entity to use the property. This harsh rule should be substantially changed. In the first place, a retroactive effective date is particularly inappropriate as to foreign-use property and other property not the subject of the Ways and Means Committee Oversight Subcommittee's hearing on federal leasing practices (February 28, 1983). Secondly, it should be sufficient that either the lessor (or predecessor) or the lessee (or successor) have had a binding contract to acquire or use the property. Moreover, if the tax-exempt entity or the lessor had made a significant financial commitment pursuant to a written arrangement prior to the effective date and the property is placed in service before January 1, 1984, this should suffice. There is ample precedent for the modifications we propose.

Conclusion

We share the Congressional concern about preventing the abuse of lease financing by governmental units and other tax-exempt entities. However, we believe that S. 1564, in its present form, would have serious adverse effects upon those who produce short-lived high technology products and those who seek to export U.S. products and compete in foreign markets. Also, the stringent effective date should be tempered.

The CHAIRMAN. Senator Long?

Senator LONG. No questions.

The CHAIRMAN. Senator Grassley?

Senator GRASSLEY. No questions.

The CHAIRMAN. Do I understand the chamber supports this bill, with the exceptions noted, Mr. Alexander?

Mr. ALEXANDER. The chamber does support the basic intent of the bill and thinks that it is a worthwhile bill and a general step in the right direction, Mr. Chairman.

The CHAIRMAN. I might just address this general question.

As I understand it, Mr. Bratton, Kansas Wesleyan is not involved—it is not a problem that you have at Kansas Wesleyan. You are appearing on behalf of the independent colleges. Is that correct?

Mr. BRATTON. Yes, Senator. I'm not here on behalf of my institution.

The CHAIRMAN. You haven't sold the campus to the alumni?

Mr. BRATTON. No, sir.

The CHAIRMAN. Now, you know that the Federal Government gives substantial subsidies to private colleges through their tax exemption, and I guess the question you have to ask is: Isn't that enough? Why do we have to start now providing negative tax rates through the sale of tax benefits? Where do we stop? If we need to appropriate money or in some other way bail out colleges because you've said we've gone from boom to bust, Mr. Hooker, I guess that's a question we have to ask.

We are wrestling with the Tax Code, trying to make it fair and close some of these loopholes—I think we have to think of a bigger word than "loophole" for some of the practices occurring in this area.

Is there an answer? We are trying to find an answer. The tax exemption ought to be enough, shouldn't it?

Mr. HOOKER. Well, sir, if the tax exemption were enough, I wouldn't be sitting before you now. The real problem is that underendowed colleges are facing a debt burden for costs that they committed themselves to during the period of expansion. And the baby boom has contracted; the number of 18-year-olds in the country is declining.

Many colleges are going to need something to get them through the next decade, and I feel that legislation designed specifically for that purpose may be too little and too late for many of them.

The CHAIRMAN. Now, as I understand, you have been in the process for about a year.

Mr. HOOKER. Yes, sir.

The CHAIRMAN. How does that work? Do you just sell it to some alumni, and then they lease it back to you?

Mr. HOOKER. Well, we will if they accept. We have set out to structure sale leasebacks as a way of refinancing short-term debt.

I realize that this can be viewed as using a tax loophole, but I think one has to look at the use that is to be made by such a transaction in deciding whether it is morally appropriate to do something like that.

The CHAIRMAN. Well, I understand that they have been working on it for some time, and we are sympathetic with them. But you know, you could extend it to selling the Capitol. We've got a big deficit—$200 billion. I don't know what the Capitol would bring, but—[Laughter.]

Perhaps we could just sell it a room at a time, maybe. This could be the "Long Memorial", of whatever. [Laughter.]

He's not leaving, or anything, but—[Laughter.]

So we have all kinds of potentials.

But I think that's the purpose, and I don't think anybody here suggests we shouldn't take a look at it.

Mr. HOOKER. Yes, sir.

The CHAIRMAN. I want to ask Mr. Alexander a question. As I look back, in 1981 we talked about ACRS. We talked about spurring investment not exports. Now we say we've got to have certain changes, that S. 1564 would adversely affect exports. Is there a contradiction there?

Mr. ALEXANDER. No, I don't think there is, Mr. Chairman. I think, in thinking about ACRS and ADR, we have two things in mind, and both affect jobs—jobs of people who actually make the products and build up the buildings, and jobs of people who use the products and occupy the buildings.

I think we shouldn't lose sight of the fact that this is one of the few means of permitting U.S. manufacturers to compete effectively with their foreign rivals.

Senator LONG. I'd like to ask Mr. Alexander a question.

The CHAIRMAN. Sure.

Senator LONG. Mr. Alexander, you had a chance to collect the tax in support of government as well as to represent taxpayers; isn't that correct?

Mr. ALEXANDER. That is correct. I'm a former tax collector, just like St. Matthew, sir. [Laughter.]

Senator LONG. So you've had a chance to be on both sides of that fence.

Mr. ALEXANDER. That's correct, sir.

Senator LONG. You are familiar with the fact that we have tax subsidies in the law.

Now, I, for one, have sponsored legislation that amounts to a tax subsidy. When you find something that is sufficiently useful, that ought to be subsidized. As a member of this Finance Committee for more than 30 years, I think we ought to change the tax law to encourage the kind of conduct that we think needs protecting.

Can you describe for us some subsidies that you folks encounter when you are competing with foreign countries in the trade area?

Mr. ALEXANDER. Well, the subsidies are ways countries use to make the foreign product more competitive from the price standpoint.

Let's take Japan. Japan has an elaborate means, a government-sponsored means, of financing its exports. And it has ways, of course, of discouraging imports. Forget the latter; the former goes to price.

As to the Airbus, the competitor of the planes that you discussed to some extent this morning and which you will hear more about in a few minutes, the emphasis of course is a governmental initiative. France and other countries have an elaborate means, as the

Committee on Banking examined in detail in the export-import bill that I referred to, of financing their exports, thereby making it very difficult for us to compete unless we have some adequate means of competing with them fairly and reasonably.

But this bill would have the unfortunate effect of discouraging U.S. exports by eliminating one of the few GATT-permissible, GATT-neutral means that we have of existing in this worldwide competition.

Senator **Long**. Some time ago I asked someone who is very knowledgeable in the area to discuss with me the relative value of currencies and the terrible deficit we are facing.

She said that the difference in currency values was mainly found in the Japanese yen and the American dollar. Accordingly, the Japanese are selling us sophisticated equipment, automobiles, parts of machinery, at what amounts to a 40 percent discount, because of the currency difference.

Has that been a problem as far as American trade?

Mr. **Alexander**. That certainly has, sir. And, as the Banking Committee pointed out, the result has been the loss of U.S. exports to foreign competitors able to offer cheaper financing made available by their official financing entities.

Senator **Long**. So we not only have the problem of the financing but also, to compound the problem, we are up against the currency problem, are we not?

Mr. **Alexander**. And that is a problem that is not solved through the tax laws, but we are up against both problems.

Senator **Long**. Well, you can't blame American producers for trying to protect jobs in America. I think we must encourage our producers to be competitive and to continue to be productive; because, if they are not, our job market will suffer, and that is what we are seeking to protect.

Mr. **Alexander**. That is correct.

Senator **Long**. You have testified that we should not act to offset America's competitive position in world trade unless we get something in return for it.

Mr. **Alexander**. That's correct.

Senator **Long**. Thank you.

The **Chairman**. Thank you very much, and we will be in touch as we work through the legislation. We will obviously be in touch with probably every member of the panel or your representatives, and we appreciate your being here this morning. Your entire statements will be made a part of the record.

I am going to call up the next two panels:

Jack Lissenden, director of finance, city of Richmond, Va., on behalf of the Municipal Finance Officers Association, Chicago, Ill.; the Honorable Jim Scheibel, councilman, city of St. Paul, St. Paul, Minn.; Peter Bell, executive director, accompanied by Sheldon L. Schreiberg, counsel, National Housing Rehabilitation Association, Washington, D.C.; and Michael L. Ainslie, president, National Trust for Historic Preservation, Washington, D.C.

Let's have all four together.

Mr. Lissenden.

Mr. **Lissenden**. Yes, sir.

The **Chairman**. Do we have all four witnesses here?

Mr. **Bell.** I am Peter Bell. Mr. Scheibel is right here.

The **Chairman.** Mr. Ainslie? Fine, you are all here.

Let me indicate that your entire statements will be part of the record, but if you can, address the principal concerns you have, if any, with the legislation.

Let me also indicate to those in the back of the room, there are some seats up front, and there are seats available in Russell Building, 325. I think there are about 100 or 200 people over there, so there is some interest in this legislation.

Go ahead.

STATEMENT OF JACK LISSENDEN, DIRECTOR OF FINANCE, CITY OF RICHMOND, VA., ON BEHALF OF THE MUNICIPAL FINANCE OFFICERS ASSOCIATION, CHICAGO, ILL.

Mr. **Lissenden.** I am Jack Lissenden, director of finance for the city of Richmond, Va., and I am speaking for the Municipal Finance Officers Association.

The MFOA became interested in this hearing because S. 1564 restricts financing arrangements which are serving as alternatives to loans in the use or acquisition of capital assets by State and local governments. We are concerned that the proposed legislation may restrict transactions which have real economic substance apart from tax considerations.

I should point out that the MFOA has not established a policy on this yet, but they have appointed a task force which has considered it, and we make recommendations to the executive board in September which will be adopted as a policy at that time.

Our task force believes that the proposed legislation places blanket restrictions on all lease financing for equipment or real property used by State and local governments. We submit that distinctions should be made which separate our proper uses and those situations where abuses are claimed to exist.

The task force feels that the imposition of an extended depreciation schedule is not acceptable when new equipment is acquired by lease or existing equipment is rehabilitated after it has been sold to private parties and leased back, and when real property is sold and leased back by a State or local government and the property is rehabilitated or constructed.

One of our major concerns is that the legislation will raise the cost to State and local governments of leasing equipment in relation to the cost to private firms. Why should a State or local government pay more to lease a copying machine than a company in a neighboring building? Our estimates are that it is going to cost us between 8 and 15 percent more to lease under the terms of this law.

We think also that Congress intended the use of IDB's for public rehabilitation of projects which are older and historic projects.

The task force is recommending that MFOA not oppose legislation to restrict the use of tax-exempt financing and accelerated depreciation in the refinancing by sale and leaseback of assets already owned by a State or local government when no rehabilitation has been made to that property.

With regard to the retroactive effective date, it is our belief that a transition rule should be adopted that will allow projects that were substantially underway, but short of a binding contract, the opportunity to be finalized because of the expenses incurred by the participants in negotiations that were heretofore legal. This is in no way a conflict for the MFOA's policy on industrial development bonds.

In closing, we recommend that Congress focus on the alleged abuses and discuss them with the appropriate representatives of State and local governments, and that less restrictive legislation rather than the present scatter gun approach is needed.

That's all, sir.

[Mr. Lissenden's prepared statement follows:]

MUNICIPAL FINANCE
OFFICERS ASSOCIATION

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Summary Statement
Jack Lissenden, Director of Finance, Richmond, VA
on behalf of the
Municipal Finance Officers Association (MFOA)

(1) Today's hearing has captured our attention because it restricts a new financing arrangement which is serving as an alternative to loans in the use or acquisition of capital assets by state and local governments. We are concerned that the proposed legislation may restrict transactions which have real economic substance apart from tax considerations.

(2) MFOA has not yet approved an official policy on leasing, but a Task Force has developed a recommended policy.

(3) Our Task Force believes the proposed legislation places blanket restrictions on all lease financing for equipment or real property used by state and local governments. We submit that distinctions should be made which separate out proper uses and those situations in which abuses are claimed to exist.

(4) The Task Force feels the imposition of an extended depreciation schedule is not acceptable when:

- new equipment is acquired by lease or existing equipment is rehabilitated after it has been sold to private parties and leased back, and
- real property is sold and leased back by a state or local government and the property is rehabilitated or constructed.

(5) One of our major concerns is that the legislation will raise the cost to state and local governments of leasing equipment in relation to the cost to private firms. Why should a state or local government agency pay more to lease a copying machine than a company in a neighboring building?

(6) The Task Force is recommending that MFOA not oppose legislation to restrict the use of tax-exempt financing and accelerated depreciation in the refinancing by sale and leaseback of assets already owned by a state or local government when no rehabilitation is made to the property.

(7) With regard to the retroactive effective date, it is believed that a transition rule should be adopted that will allow projects that were substantially underway, but short of a binding contract, the opportunity to be finalized because of the expenses incurred by participants in negotiations that were heretofore legal.

(8) In closing, we recommend that Congress focus on the alleged abuses and discuss them with the appropriate representatives of state and local governments. Less restrictive legislation rather than the present "scatter gun" proposal is needed.

EXECUTIVE OFFICES 180 NORTH MICHIGAN AVENUE CHICAGO ILLINOIS 60601 312 977-9700

Mr. Chairman and Members of the Committee, my name is Jack Lissenden. I am Director of Finance, City of Richmond, Virginia. I am here to testify on behalf of the Municipal Finance Officers Association (MFOA). The Municipal Finance Officers Association is a professional organization representing 9,200 state and local government finance officials, appointed or elected, and other public finance specialists.*

The subject of today's hearings -- proposed restrictions on leasing by state and local governments — has captured our attention because it restricts a new financing arrangement which is serving as an alternative to loans in the use or acquisition of capital assets by state and local governments. We are concerned that the proposed legislation may restrict transactions which have real economic substance apart from tax considerations.

From the outset let me make it clear that the Municipal Finance Officers Association has not yet developed an official policy statement with regard to this form of financing. At its Annual Meeting in June, the Association created a Leasing Task Force to recommend a policy position on leasing by state and local governments. Our Task Force has met and drafted a policy statement for consideration by the Association's Committee on Governmental Debt and Fiscal Policy. When approved by that Committee and passed by the Executive Board, the statement will become official MFOA policy.

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* Questions concerning this testimony may be directed to Catherine L. Spain, Director, Federal Liaison Center, Municipal Finance Officers Association, 1750 K St., N.W., Suite 200, Washington, D.C. 20006 (202) 466-2014.

In the meantime, we feel compelled to react to S. 1564 as practitioners and experts in public finance. The Association has developed a body of knowledge on the subject of governmental leasing by state and local governments through the research activities of its Government Finance Research Center. Recently, MFOA published two volumes which organize and present the technical subject of leasing in a compact and objective way: Creative Capital Financing for State and Local Governments and A Guide to Municipal Leasing.

Lease financing has grown in use by state and local governments as a result of a number of legal and economic factors.

- Leasing often is a suitable and economic method of financing capital assets that are too expensive to fund from just one fiscal period, but have useful lives too short to justify the issuance of long-term bonds. Examples are ambulances, computers and office machinery.
- Governments may use leasing as an alternative to bond financing because of high interest rates, the difficulty of timely referenda on bond issues for essential facilities, or because legal debt limits have been reached.
- Governments that are hard-pressed fiscally may have to use leasing to replace equipment and acquire other capital assets in order to spread scarce resources because it may be more economical than other methods of financing.
- The need that a government has for a capital asset may be temporary, or rapid changes in technology may make ownership of equipment impractical.
- Leasing offers a method for privatizing public services and fostering public-private cooperation.

As a result, lease financing is an important alternative to traditional sources of capital financing.

In developing a policy to recommend to the MFOA, our Leasing Task Force expressed its concern that the proposed legislation places blanket restrictions on all lease financing for equipment or real property used by state and local governments. We submit that distinctions should be made which separate out proper uses and those situations in which abuses are claimed to exist. Unfortunately, the proposed legislation makes no distinction and would adversely impact all lease financing.

The Task Force is recommending that MFOA not oppose legislation to restrict the combined use of tax-exempt financing and accelerated depreciation in the refinancing by sale and leaseback of assets already owned by a state or local government when no rehabilitation is made to the property. This means that the Association would not condone sale-leaseback arrangements that have been structured to obtain funds to refinance a facility that is sold and leased back in those cases where tax-exempt financing is used for the acquisition of the property by the owner/lessor. No objection would be raised to such transactions if funding for the project is raised by private funds.

The MFOA Leasing Task Force feels that legislation to limit these transactions is appropriate. However, the Task Force feels the imposition of an extended depreciation schedule is not acceptable when:

- new equipment is acquired by lease or existing equipment is rehabilitated after it has been sold to private parties and leased back, and
- real property is sold and leased back by a state or local government and the property is rehabilitated or constructed.

The use of an extended rather than an accelerated cost recovery system of depreciation when the affected property is leased back by a governmental entity causes us great concern. The potential benefits of investment for public infrastructure and other public capital projects are reduced when compared to those for private investment. In effect, the state-local sector is put at a competitive disadvantage, because the after-tax cost of capital investments by private corporations will be skewed to investments in non-governmental areas.

One of our major concerns is that the legislation before Congress extends beyond the alleged abuses cited by the sponsors of the various bills. In particular, we point to the provision that will raise the cost to state and local governments of leasing equipment in relation to the cost to private firms. Why should a state or local government agency pay more to lease a copying machine than a company in a neighboring building? The MFOA would oppose the imposition of an extended depreciation schedule on leased equipment. The proposed policy does not address the problem of vague legislative language relating to short-term and casual leases because our proposed policy would preclude the need for such distinctions. We do not know of abusive transactions in the equipment leasing area nor do we believe the potential for them to occur exists.

Restrictions on the use of the investment tax credit (ITC) for public rehabilitation projects are opposed in the proposed policy, regardless of whether tax-exempt financing is used to finance the projects. It was Congress' expressed intent in extending the ITC to tax-exempt entities to encourage such renovation. The Leasing Task Force has taken the position that we should support the combined use of industrial development bonds (IDBs) and the investment tax credit for the rehabilitation of older and historic buildings because of the important renovation work it encourages. The drafters of our proposed policy have expressed the opinion that this endorsement of IDB financing does not conflict with MFOA's longstanding policy to restrict small-issue industrial development bonds because the public entity remains financially and functionally involved for those projects our policy supports.

With regard to the retroactive effective date, it is believed that a transition rule should be adopted that will allow projects that were substantially underway, but short of a binding contract, the opportunity to be finalized because of the expenses incurred by participants in negotiations that were heretofore legal.

As you know, public infrastructure needs are great. State and local governments have logically designed vehicles to employ every financial tool available. If Congress wishes to change the rules to create greater restrictions on lease financing for states and localities, it should do so in a neutral way, by also taking away the incentives to private investment that foster inequities in the allocation of capital. Not to do so will further impair the ability of governments to compete for capital.

The current era of austerity forces governments to approach the mid-1980s with a surplus in tough fiscal choices and a deficit in available resources. The need for fiscal survival compels governments to search constantly for ways to just get by. We urge that an important alternative financing mechanism not be eradicated in the rush to squelch a few abusive practices. Some other issues we think need to be considered in connection with this legislation are summarized below:

- It has been suggested that the Congress is overreacting to a problem at the federal level by restricting a practice at the state and local level it perceives to be out-of-hand. As noted in the Congressional Budget Office study, Trends in Municipal Leasing, the volume of leasing is unknown. If tax-motivated leasing by federal agencies is the problem Congress is trying to correct, we think it is extremely unfair and restrictive to disadvantage state and local governments with respect to innovation.

- Public officials have observed that this form of financing involves the "privatization" of public services, a practice that has been encouraged by the Administration and by individual federal agencies. Sale-leaseback arrangements have provided a very direct method for obtaining participation from the private sector in joint ventures.

- We would like to ask why Congress is involving itself in these questions when courts, revenue rulings, and other legal authorities have already distinguished between the phony and the real with respect to leases and service contracts. Some taxpayers may be attempting to circumvent the rules, either regarding state-local or private facilities, this does not mean that they will succeed or that there is any need for legislation directed at state and local governments.

- We remind you that the tax benefits associated with sale-leasebacks are being considered in a vacuum. For tax years after the period of depreciation ends and/or the investment tax credit has been taken, the effects on federal revenues will be diminished as the taxable income of the private investor rises.

In closing, we recommend that Congress focus on the alleged abuses and discuss them with the appropriate representatives of state and local governments. Less restrictive legislation rather than the present "scatter gun" proposal is needed.

Thank you Mr. Chairman and Members of the Committee for this opportunity to share our views. I will be happy to answer any questions you may have.

The **Chairman**. As I understand, you will be meeting in September?

Mr. **Lissenden**. Yes, sir. The executive board of MFOA will be meeting in September.

The **Chairman**. What time in September.

Mr. **Lissenden**. It is late in September, I believe. It will be late September, sir, because another committee has to consider it and inform us.

The **Chairman**. You may want to meet a little earlier.

Mr. **Lissenden**. We will try.

The **Chairman**. Let's see—Mr. Scheibel?

STATEMENT OF HON. JAMES SCHEIBEL, COUNCILMAN, CITY OF ST. PAUL, ST. PAUL, MINN.

Mr. **Scheibel**. Mr. Chairman and members of the committee:

Thank you for the opportunity to speak this morning. I am Jim Scheibel. I am a member of the City Council in St. Paul and also a member of the Civic Center Authority.

I want to make clear at the outset that my concern this morning is not with the basic legislation introduced by you, but with the provisions which are seriously damaging important projects in progress in my city.

I am asking that you act immediately to include reasonable transition language in the legislation so that projects which have already entered into contractual commitments and are, in fact, underway may proceed.

Two critically affected projects are our civic center auditorium and parking ramp project, and our Ordway Music Theater. The auditorium renovation represents a long-needed convention facility, and the parking ramp improvements are already underway, the need being such that delay beyond this construction season could not be contemplated.

As a package, that project received final authorization in April of this year, and we were prepared to issue bonds on June 15.

The Ordway Music Theater is also under construction, its board having approved the sale-leaseback concept as an aspect of financing in January of this year, and the city having indicated its approval in resolutions dating back to the fall of 1982.

Quick action by this committee to provide language enabling those projects which have already entered into contractual commitments to proceed would provide Congress with the opportunity to debate more extensively the merits of the basic legislation without punitive effects on projects caught in transition.

Please act immediately to provide this transition language for lease financing so that projects already underway may proceed.

Thank you.

The **Chairman**. Thank you, Mr. Scheibel.

[The prepared statement follows:]

TESTIMONY TO FINANCE COMMITTEE
REGARDING
S. 1564

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

Thank you for the opportunity to address you this morning. I am Jim Scheibel, Chairman of the Finance Committee of the Saint Paul, Minnesota, City Council and a member of the Civic Center Authority. The City of Saint Paul is extremely concerned about the current impact of bills recently introduced in the House by Representative Pickle and in the Senate by Senator Dole concerning lease financing by municipalities and other public agencies. I want to make clear at the outset that my concern this morning is not with the basic legislation, but with provisions which are seriously damaging very important projects in progress in Saint Paul. I want to stress the need for quick action in order to solve the very significant problems in our city. On June 19th, in testimony before the House Ways and Means Committee, I was given assurance that Congress had every intention of acting quickly on this important piece of legislation. Now, a month later, important projects in Saint Paul remain stalled. We are prevented from beginning very important renovation work at our Saint Paul Civic Center during our short construction season in Minnesota. If we do not receive prompt attention by some sort of transition language, we will jeopardize a major construction project and put the City in a significant cash flow bind. I would again encourage members of this Committee to act quickly on reasonable transition language that would enable those projects which have already entered into contractual commitments to proceed. Such an approach will provide Congress with an opportunity to debate more intensively the merits of the basic legislation. What I am asking for this morning is a reasonable approach to transition rules which permits projects which are near completion to escape the penalties that this bill's introduction imposes.

I would now like to address in particular the projects which are affected by this piece of legislation.

1. Civic Center Auditorium and Parking Ramp Remodeling Project

   For a number of years the City of Saint Paul has endeavored to find the financial resources to remodel its older municipal auditorium, originally constructed in 1932. We are in need of a renovated convention center. At the same time, we need immediate structural improvements to the parking facility which has experienced severe deterioration due to salt intrusion in the concrete. The combination of these two projects total $10 million of very necessary repairs. We retained financial and legal experts last July to assist in structuring financing which we could afford. The plan, which was approved in concept last September and which received formal, final authorization in April of this year, involves the sale and leaseback of our entire Civic Center complex to a group of private investors. After considerable community discussion and very involved financial and legal arrangements, we were prepared to issue bonds to finance this project on June 15 of this year. We received, in mid-May of this year, a formal pledge of bond insurance which provides the security necessary to sell the bonds. All of the legal documents are now drafted and a preliminary, official statement has been released.

All of these efforts were done in good faith and with no information that the entire method we were relying on to complete the project during this construction season was going to be placed in doubt by H.R. 3110 and S. 1564. It is critical that this important construction project proceed this summer. Thus, we are requesting immediate action by Congress to provide for transition language necessary so that the important deliberations of this committee on the issue surrounding H.R. 3110 can proceed without impeding our ability to complete work that has been over twelve months in the planning and which has cost, to date, in excess of $300,000.

I would add that the Civic Center project has already begun construction on a first phase of the parking ramp improvements. We could not delay any further on this particular portion of the project, and we have only temporary financing in anticipation of securing the final bond financing from the sale-leaseback.

To summarize, construction is underway, final approval from the City Council was issued in mid-April, and bonds were scheduled to be sold June 15. We are requesting immediate release from the punitive language presently existing in S. 1564 in regard to projects in process.

2. Ordway Music Project

Also under construction is the Ordway Music Theatre, a 1,800 seat music hall which will house our Saint Paul Chamber Orchestra and the Minneapolis Opera Company. In excess of $21 million has been privately raised, to date, to support this important project. An additional $17 million is necessary to complete the project and to provide for an operating endowment. Since last summer the board of the Ordway Theatre has contemplated the sale and leaseback of the facility in order to reduce the amount of funds that would have to be raised to support the project. The Ordway Music Theatre Board approved the sale-leaseback concept in January of this year and the City has indicated its approval in a number of resolutions dating back to the Fall of 1982. As with the Civic Center Auditorium and parking ramp facility, the Ordway Music Theatre Board has expended considerable sums of money on financial analysis and legal arrangements to complete this important transaction. Again, we are asking for immediate release from the provisions of S. 1564 which undercut this important project in progress.

My suggestion for transition language is that projects which received formal authorization from the government body of the City or from the official board of the tax-exempt entity, before May 23, 1983, be allowed by Congress to proceed. I believe this approach would allow all projects that have a legitimate claim to being "in progress" to proceed without loss of the good faith and dollars already invested. This would also give the Congress a greater opportunity to act on the overall merits of this legislation and to place the kinds of limitations I think we all agree are necessary in order that this particular form of financing is not abused.

Before closing, I would like to congratulate Senator Dole on eliminating one feature of the bill originally introduced in the House by Representative Pickle. As you are aware, the initial legislation affected the ability of private for-profit entities to receive rehabilitation tax credit for facilities financed with tax exempt bonds. This problem has been eliminated in the revised legislation and for this we are deeply grateful. As a result, our long awaited renovation of the Union Depot Train Station is now proceeding toward bond closing within the next two weeks.

Please act immediately to provide transition language regarding lease financing, as well, so that punitive effects now being imposed on projects already underway are relieved.

Thank you.

STATEMENT OF PETER BELL, EXECUTIVE DIRECTOR, NATIONAL HOUSING REHABILITATION ASSOCIATION, WASHINGTON, D.C.

Mr. **Bell**. Mr. Chairman and members of the committee, I appreciate the opportunity to appear before you today.

The National Housing Rehabilitation Association, a trade group of real estate developers, equity syndicators, and related professionals engaged in multifamily rehab and historic preservation, support the efforts of the sponsors of S. 1564 in seeking legislation to discourage tax-exempt entities from raising revenue by creatively packaging sale-leaseback transactions to take advantage of Federal tax laws.

S. 1564 is a far more attractive version of this legislation to us than its House counterpart, in that it targets the denial of rehab investment tax credits to IDB-financed projects only to the extent that projects are actually to be occupied by tax-exempt users upon completion. An amendment to conform the House version of the bill to the Senate language will be introduced by Mr. Rostenkowski in the markup of that bill.

There are, however, a few areas of the bill that need to be addressed. There is one that needs to be further refined, and two others on which we would like to appeal to your sense of fairness and reason.

As far as refining the bill, the definition of tax-exempt use in the bill needs to be clarified to indicate that the term refers only to properties that are to be occupied by tax-exempt users after the rehabilitation has been completed, and not to properties that are actually owned by a tax-exempt entity and leased out to a profit-motivated developer to be recycled and placed into the market for taxpaying users.

That change could be accomplished very simply by changing the word "use" to the word "occupied" twice in the legislation.

The second area on which we think a degree of fairness needs to be put into the bill is the 50-percent threshold requirement, which would allow up to 50 percent of a property to be used by tax-exempt users and still not qualify it as tax-exempt use property.

It is difficult to pick an arbitrarily derived number like that. You may have instances where a building has 20 percent use by tax exempts and is a sale-leaseback, and you may have instances where a property is 70 percent used by nonprofits and is not a sale-leaseback.

It is quite possible that organizations like ours or the Committee for an Effective Congress, or whomever, may go to lease space in a building that was financed with tax-exempt industrial development bonds subsequent to its development.

So I think you really need to look at the actual facts and circumstances in any particular case.

Our last point is that the effective date of this bill needs to be changed. The contract date is a rather late point in the process. Great expenditures have been made for architectural and legal work, for surveys, and so forth, and to cut off the use of this financing vehicle after many projects were started in accordance with the law when they were implemented is to penalize institutions that cannot afford to handle that penalty at this point.

[The prepared statement follows:]

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Statement of Peter H. Bell
Executive Director of the
National Housing Rehabilitation Association
Before the Senate Finance Committee
Concerning the Proposed Governmental Lease Financing Reform Act (S. 1564)

July 19, 1983

Mr. Chairman and Members of the Committee, I thank you for the opportunity to appear before you today to offer the support of the National Housing Rehabilitation Association for passage of legislation that discourages tax-exempt entities from seeking to raise revenue by creatively packaging sale/leaseback transactions to take advantage of federal tax laws.

I am also grateful to have this opportunity to call your attention to several areas of potential difficulty that would be created for commercial and multifamily rehab projects by this bill. If enacted as currently drafted, S. 1564 would create unintended "side effects" that could adversarily impact downtown revitalization efforts in every older city in the nation. These "side effects" could be addressed, however, by simple changes in the wording of the proposed legislation.

More specifically, as explained by Senator Dole upon introducing S. 1564, the bill aims at addressing abuses in lease financing arrangements by governments and other tax-exempt entities by eliminating the tax-credits and accelerated depreciation for property subject to tax-exempt leases.

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A drafting error in the House version of the bill would have denied the commercial rehab and historic preservation investment tax credits to any project financed with tax-exempt industrial development bonds. S. 1564, much to our satisfaction, attempts to clarify that the tax credits should only be denied in any case in which there is a "tax-exempt user," presumably meaning the actual after-rehab occupier of the property.

Problems arise, however, over the definition of "tax-exempt use" of a property.

It has been our understanding that this legislation was written to target its effect, principally, to precluding situations where a tax-exempt entity owns property, sells or leases it to a private partnership, and re-leases it back for its own use. This sort of transaction has little practical purpose other than enabling outside investors to take advantage of the tax benefits resulting from ownership of the property and allowing the tax-exempt entity to cash in on the value of those benefits, while still retaining use of the property.

As drafted, S. 1564, would have the broader effect of also denying the tax credits to projects in which a property is owned by a tax-exempt entity, leased long-term to a developer who rehabilitates it and leases it on the open market to taxpaying users. Because of the tax-exempt entity's ownership of a property, it could be construed to be a "tax-exempt use" property, despite the fact that it would not be occupied by a tax-exempt user after rehabilitation.

Leasing property long-term for development, rather than purchasing it outright, is a common element of many real estate projects and is often necessary to reduce front-end capital requirements. In rehab, where front-end cash requirements are unusually heavy, the added leverage available through leasing site control is particularly important. Without that option, developers would face even greater difficulty in packaging financing to recycle older downtown properties, such as obsolete schools, outmoded firehouses and abandoned YMCA's, to new uses.

The difficulty posed by this bill could be addressed by simply substituting the word "occupied" for the word "used" in two of its paragraphs, clarifying that it is the actual user of the renovated property after rehab which determines whether a property is to be classified as "tax-exempt use property."

Our second concern arises out of the bill's provision exempting property from classification as "tax-exempt use property" unless more than 50% of its use is by a tax-exempt entity. While we appreciate this improvement over the House bill which had no tolerance for partial use by tax-exempt users and would not even allow, for example, non-profit health clinics in tax-exempt bond financed elderly housing, we find the arbitrarily derived 50% threshold to be problematical.

It is quite possible that not-for-profit organizations such as health clinics, legal aid offices, educational institutes or associations such as our own, might seek space in office complexes built with tax-exempt bond financing. Limiting the amount of space that such groups could occupy decreases location options for them and limits the potential market for office space in IDB-financed developments, threatening both the economic feasibility of specific projects, as well as the general viability of some downtown revitalization efforts.

Instead, the facts and circumstances of each case must be examined individually to determine whether a transaction is actually an abusive sale/leaseback transaction of the type this legislation seeks to curb.

Our last problem arises out of the "Effective Dates" contained in the proposed legislation. While we sympathize with those in Congress who are concerned with curbing the expansion of the objectionable uses of this financial technology, it is, at the moment not prohibited by law. We are aware of several transactions, all within the bounds of current law, which are in processing, but which did not have binding contracts in effect as of May 23, 1983.

Nevertheless, significant expenses have been incurred and outlays have been made pursuant to these transactions, prior to reaching the contract stage. Tremendous investments of time and financial resources remain at risk. Their loss, at this point, would severely hurt institutions who began undertaking "self-help" projects that were completely in conformity with the law at the time of their inception. Losses incurred as a result of the retroactive coverage of this proposed law would be an undue penalty.

The effective date should be immediately upon enactment. Deals which had substantial work done prior to introduction of the House bill on May 23, 1983 should, in all fairness, be allowed to go forward.

Objectional practices should be curbed by the swift passage of a properly drafted and targeted law, effective upon enactment. To the extent that the National Housing Rehabilitation Association can assist the Committee in obtaining such a law, we pledge our fullest cooperation.

Thank you for the opportunity to testify today. I will be pleased to answer any questions you might have.

STATEMENT OF MICHAEL L. AINSLIE, PRESIDENT OF THE NATIONAL TRUST FOR HISTORIC PRESERVATION, WASHINGTON, D.C.

Mr. AINSLIE. Mr. Chairman, the National Trust for Historic Preservation supports the intent of discouraging abuses that this bill attempts to address, but we feel that it goes much further and will have a major detrimental effect on the restoration and rehabilitation of historic buildings in our country.

Specifically, by denying credits to projects which are owned by a tax-exempt entity but leased to other entities, either for-profit developers or, in many cases, individual renters, this bill will discourage those preservation projects.

Let me be specific: The Willard Hotel project here in Washington, which is scheduled to begin rehabilitation within two weeks, will be completely undermined by this bill. The language of tax-exempt use property, as Mr. Bell has pointed out, is language that is much broader than the word use might apply. By referencing the regulations, it clearly includes the category of property that is owned by a nonprofit and leased to a non-tax-exempt entity. That project and scores of others around the country will be adversely affected.

Let me give you one other example. In Springfield, Mass. there is a community organization called "The Brightwood Development Corporation" that has syndicated and raised $300,000 of equity for a project there to provide low-income housing to indigenous residents of that community. They have used a $900,000 industrial revenue bond; they have raised another $150,000 from the National Trust and other grant sources. The lessees, the renters, will be low-income residents of that historic district. That project would be undermined by this bill, as well. The language is much too loose with regard to tax-exempt use properties.

Specifically, in the short time allowed, let me make three recommendations for changes in the legislation:

We believe that section 2(c) denying the rehabilitation credit for tax-exempt use property should be deleted; or, if that is politically unacceptable, at a minimum we feel that certified historic rehabilitations should be provided an exception in section 2(c).

Next, we believe that in section 2(a) the words "tax-exempt use property," should be restricted to mean property actually occupied by a tax-exempt entity under a lease in the targeted transaction.

Finally, we believe that if there are limits imposed on the availability of the investment credit, that there should be possibly an election, a flexible election, between using the investment credit or using financing provided by industrial revenue bonds.

Unfortunately, we believe this bill has gone far beyond the intended purpose that you stated in your original floor statement and is a broad-scale attack on the most successful 1981 investment credits for certified rehabilitation.

Thank you.

[Mr. Ainslie's prepared statement follows:]

STATEMENT OF MICHAEL L. AINSLIE
PRESIDENT OF THE NATIONAL TRUST FOR HISTORIC PRESERVATION
BEFORE THE SENATE FINANCE COMMITTEE
CONCERNING THE PROPOSED GOVERNMENTAL LEASE FINANCING REFORM ACT (S.1564)

July 19, 1983

Mr. Chairman and Members of the Committee, I appreciate this opportunity to appear as an advocate for America's scarce historic properties. We urge retention of the successful tax incentives to encourage quality rehabilitation of historic properties and their return to economic and social utility. The rehabilitation investment credit is the most important single reason developers cite for getting involved with historic redevelopment.

While we certainly understand your purposes in introducing S. 1564, and are in sympathy with its intent to curb sham lease transactions, the bill would have an unfortunate, detrimental impact on historic rehabilitation projects. As drafted, the bill does indeed go well beyond prevention of the abuses you have targeted. It would deny the rehabilitation tax credit and 15-year straight-line cost recovery in legitimate and desirable transactions, including where a tax-exempt entity is merely the lessor of the historic property.

As an example of immediate concern to the Trust, S. 1564 would undermine a most important and long awaited rehabilitation project here in Washington -- that of the historic Willard Hotel on Pennsylvania Avenue, the rehabilitation of which is scheduled to start within the next two weeks (the Trust sponsored a decisive feasibility study of its rehabilitation in 1973). The Congressionally chartered Pennsylvania Avenue Development Corporation (PADC) has leased the Willard to the Oliver T. Carr Company for up to 99 years for rehabilitation and reuse as a hotel mixed with commercial and retail space. PADC is a tax-exempt lessor, retaining ownership as a public steward of this historic property. Accordingly, under Department of the Treasury regulations and interpretation of Internal Revenue Code Sections 48(a)(4) and (5), the Willard will technically be "used by" a tax-exempt entity even though it will actually be occupied by a tax-paying commercial tenant that will spend millions on its rehabilitation. The result under S. 1564 is that the Carr Company would be denied the investment credit for the Department of the Interior certified rehabilitation. In addition, because the bill requires depreciation over 125% of the lease term, the Carr Company would be forced to recover its investment over a period of 124 (rather than 15) years.

We are aware of other projects in New York City, Leesburg, Virginia, and our Main Street town of Hot Springs, South Dakota, where governments similarly intend to retain ownership as public stewards of surplus historic properties, but lease them for rehabilitations involving substantial private investment. S. 1564 will also remove the economic rationale for these contemplated transactions. We do not believe that this is a fair or socially desirable result, Mr. Chairman.

Unlike the abusive sale-leasebacks in which tax deductions and credits may be created without any addition to capital account, certified rehabilitations are qualitatively different. Historic rehabilitation projects are real economic transactions where the owner or long-term lessee must substantially rehabilitate the building, put it into business or income producing use and incur a real risk of loss. Moreover, as noted below in the Inner City Venture Fund and Main Street examples, involvement of a non-profit organization, going where others fear to tread, may be the only way to get economic redevelopment and "new" rehabilitated housing underway in distressed areas. Thus, these are not the "something-for-nothing" games or tax gimmicks that you are seeking to stop.

Based upon our experience and research described more fully below, we know that older and relatively scarce historic buildings are still at a disadvantage in the marketplace, particularly with respect to financing. The federal tax incentives for historic rehabilitation are critical to at least half of the projects undertaken, and tax-exempt industrial development bond financing has helped market competitiveness in about 20% of certified historic projects to date. Importantly for historic preservation and urban revitalization efforts, the denial of the investment credit in conjunction with IDB financing will thwart significant commercial and housing rehabilitation projects in the socially and economically distressed areas that these incentives are intended to benefit.

The evidence we have about the rehabilitation market, the types of projects being encouraged and the often vital elements of the rehabilitation credit and IDB financing makes a compelling case for amendment of S. 1564.

LEGISLATIVE RECOMMENDATIONS

1) Delete Section 2(c) denying the rehabilitation credit for tax-exempt use property or, at least, make an exception in Section 2(c) for certified historic rehabilitations.

2) If the Committee decides to limit the availability of the rehabilitation investment credit where a tax-exempt entity is involved, the Committee should at least provide flexibility by allowing an election between the investment credit and IDB financing in the case of tax-exempt use (meaning tax-exempt occupied) properties. (Chairman Rostenkowski is expected to offer an amendment to H.R. 3110 to this effect.)

3) Clarify Section 2(a) so that "tax-exempt use property" is restricted to mean property actually occupied by tax-exempt entities under leases in the targeted transactions.

NATIONAL TRUST RESEARCH AND EXPERIENCE

The universe of historic buildings currently listed on the National Register of Historic Places and, thus, potentially eligible for the rehabilitation investment credit is an extremely small segment of our nation's building stock -- about 1/4 of 1% (approximately 200,000 buildings out of a total of about sixty-five million). Also by means of comparison, about 1.9 million buildings are over 30 years old and in office, retail, commercial or industrial use and, therefore, more likely eligible for the 15 and 20% tax credits. Many of the approximately 165,000 historic buildings, however, are ineligible for the historic tax credit because they are owner occupied or in other non-income producing uses.

The National Trust study, Federal Taxation and the Preservation of America's Heritage (April 1983), prepared for the Advisory Council on Historic Preservation, found, contrary to the generally held assumption, that it is not the large developer, but rather private individuals or relatively small partnerships with gross incomes under $100,000, who are using the rehabilitation incentives. They generally undertake less than one building project a year. Our research confirmed Department of the Interior statistics that at least one of every two historic rehabilitation projects would not have been possible if it were not for the existence of the targeted historic preservation tax incentives. Thus, loss of the rehabilitation credit potentially could eliminate as many as half of future projects.

Following the factor of location, developers report that the cost and availability of financing is the most important consideration when undertaking a construction project. Financing the renovation of older and historic properties suffers from inherent disadvantages in the competition for scarce investment resources: physical deterioration and often economic and functional obsolescence. Moreover, older property rehabilitations were perceived to be more difficult as to predictability of construction costs, more difficult to execute and more expensive to operate. These perceptions influence the willingness of lenders to fund rehabilitations.

Not surprisingly then, 50% of those surveyed in the Trust study considered new construction to be best in terms of the ability to obtain financing; only 14% felt that financing would be more readily available for a historic rehabilitation. The perception and reality of this financing handicap for older and historic properties emphasizes the importance of IDB assistance to these projects. Significantly, 21% of the users of preservation tax incentives reported that they had used IDB financing as a source of funding for their projects.

The National Park Service has noted that actual and planned investment in historic rehabilitation projects certified for the tax incentives has totaled $3.95 billion in the six years since the creation of preservation tax incentives. Approximately one-third of that investment was certified in 1982, indicating a growing interest in and commitment to restoration of our nation's building stock. Significantly, about half of these projects involve rehabilitation of a total of 35,547 housing units nationwide, 25,755 of which are newly created units. Over one-third, or 13,602, involve housing for low and moderate-income families. It is these projects that need the most public assistance.

Our own firsthand experience through the Trust's Inner-City Ventures Fund and the National Main Street Center confirms that the success of many local projects is due to the ability to combine a number of funding options.

Two projects in Massachusetts, assisted through the Inner-City Ventures Fund, are particular examples of this. The first, in Springfield, is a joint venture of the Brightwood Development Corporation, a neighborhood-based group, to save and reuse an historic parish hall located within the Memorial Square Historic District as a much needed neighborhood medical building. Of the total project cost of $1.35 million, $300,000 will be contributed by private investors eligible for the rehabilitation tax credit; $900,000 will be raised through the issuance of a state-financed industrial development bond, and the remaining $150,000 will come from both public and private sources, including National Trust grants and loans. Ultimately, four of the seven buildings in the district will be rehabilitated with the Trust's assistance, including the rehabilitation of a 40-unit apartment building for continued low-income rental use and the reuse of two buildings for commercial and community-oriented uses.

In Jamaica Plains, 16 largely vacant buildings of an old brewery are being purchased using federal, Trust, and other monies, and renovated for small business and light industrial use. In the first phase of this staged project, 100 new jobs will be created in this low-income neighborhood. The next phase of the program, during which the renovation of some of the larger buildings in the complex will take place, is contingent on the availability of IDB financing and additional private investment stimulated by/the rehabilitation tax credit.

Similarly, a range of projects being assisted by our National Main Street Center use a variety of financing alternatives to encourage the renovation and economic redevelopment of historic downtowns. Currently operating in 63 towns and cities in the states of Colorado, Georgia, Massachusetts, North Carolina, Pennsylvania and Texas, the Center anticipates adding four to five states next year.

Several main street projects in Grand Junction, Colorado, for example, require the advantage of both the rehabilitation credit and IDB financing. The adaptive reuse of a public school building, constructed in 1920, is planned to house the Museum of Western Colorado, which would otherwise have left the historic downtown for a new building in the suburbs. The school will be bought by a limited partnership, in combination with a non-profit general partner, renovated and sold to the Museum under a 15-year lease-purchase arrangement. It appears that this transaction would be clearly affected by S. 1564.

It is, in addition, anticipated that the most significant building in the historic downtown, the First National Bank of Grand Junction, will be saved through the use of the 25% preservation credit and tax-exempt financing. Although initially deciding to demolish the old headquarters in favor of a new bank building two blocks away, the president of the bank has agreed to present a plan to his board of directors to occupy the building for an additional year, seek its listing on the National Register of Historic Places, and then sell it to a new owner who presumably, would take the 25% investment tax credit and seek tax-exempt financing of the ultimate restoration.

CONCLUSION

These are only a few examples of the kind of energetic planning and activity being undertaken across the nation for the preservation of older and historic buildings, many of which involve tax-exempt components. The importance of both the rehabilitation credit and beneficial financing to many of these projects leads the National Trust to request the deletion of proposed Section 2(c) and to recommend the other amendments. In the event, however, that some proscription is included in the bill, it is essential in all fairness to ongoing projects to narrow its focus and include a transition rule sufficiently broad to protect projects initiated in reliance on existing law.

Mr. Chairman, in your floor statement you acknowledged concern that the rules for real property and the rehabilitation credit may go well beyond the abuses targeted. I believe that we have shown that this is the case -- with undesirable results. We look to your leadership for appropriate modifications, and we hope that the Congress will reaffirm in this legislation its commitment to the preservation of the nation's older and historic resources.

Guarding America's Heritage

National Trust for Historic Preservation

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August 10, 1983

Honorable Robert Dole
Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

Re: S. 1564: Governmental Lease Financing Reform Act of 1983

Dear Mr. Chairman:

This is in response to your questions at the July 19 hearing on S. 1564 concerning the generosity of the 25% investment credit for certified historic rehabilitations and the inherent risks in rehabilitation projects that would justify such an incentive.

I can testify with confidence that historic buildings are currently at a disadvantage in the real estate market place. I can also say with confidence that the investment credit for certified historic rehabilitation is the decisive factor in half of the projects being undertaken. As important for the future, it is the most important reason that real estate developers give for undertaking their first rehabilitation.

The National Trust, as envisioned by its Congressional charter, has worked hard over many years to encourage private involvement and investment in historic preservation. The research conducted for our report Federal Taxation and the Preservation of America's Heritage (April 1983), prepared for the Advisory Council on Historic Preservation, documented the real and perceived problems with investment in older buildings that we as advocates have been up against. These are the problems and related risks that have led to disinvestment in single buildings, in neighborhoods and, in too many cases, in whole communities. I will summarize these problems and risks here.

Fundamentally, relatively scarce historic buildings (about 1/4 of 1% of our nation's building stock) suffer from inherent disadvantages in the competition for scarce investment resources: physical deterioration and often economic and functional obsolesence. Our professional survey of real estate developers, syndicators, and counselors (who have previously not been involved in rehabilitation) revealed that older and historic buildings are perceived to be less desirable with respect to location, less attractive to prospective tenants, more difficult to predict construction costs accurately, more difficult to construct, less energy efficient, and, most importantly, more difficult to finance.

While we are working to disseminate knowledge about the methodology and economics of rehabilitation, it is in the critical area of financing of a rehabilitation project that the investment credit is most helpful. Lenders tend to look disfavorably on rehabilitation projects. This is because of their lack of experience with such projects, their fear of the surprises in rehabilitation that may increase the cost, and the lesser cash flow from the comparatively smaller historic building. Therefore, investors often must provide a greater percentage of equity capital to initiate a project. The rehabilitation investment credit is the tax advantage that is motivating investors to put up this equity capital.

While some investors may now be motivated to invest in historic buildings by the "tax shelter" attributes, the essential point is that the equity capital that credits stimulate is making feasible half of the projects being undertaken. Looking to the future of historic resources, the real significance of the rehabilitation investment credit lies in the new investors it is bringing to historic preservation and, in a broader sense, the change of attitude toward older buildings, neighborhoods, and communities. Our research found that the current tax incentives are the single most frequently mentioned reason for initiating or advising others to initiate an historic rehabilitation project.

Further, while the 25% investment credit may appear a substantial and generous incentive, it must always be viewed in comparison to the alternative investment choices that the Internal Revenue Code encourages. Of immediate competition, there are the 15% and 20% rehabilitation investment credits for the larger universe of 30 and 40 year old buildings. As you noted in 1981 when you offered the amendment to exempt historic rehabilitations from basis adjustment, there must be enough of a margin of incentive to induce taxpayers to subject themselves to the Department of Interior's certification process and the additional delays, costs, and uncertainties that it brings. Otherwise, they will choose to do nonhistoric rehabilitations or to invest in some other activity. Consequently, we believe that there must be significant incentive to encourage taxpayers to overcome the real and perceived disadvantages of a rehabilitation investment, and there must be, in any event, an adequate margin of incentive over nonhistoric rehabilitations.

As I noted in our testimony on July 19, many worthwhile projects would not be undertaken without the combination of the credit with tax benefited financing. Together they help to provide the equity and debt financing required. That is why we have urged an exemption for historic rehabilitations in the bill.

The rehabilitiation investment credits have helped to return many historic buildings to social and economic usefulness. They have helped make historic preservation a centerpiece of downtown revival and renewal in many of our cities. This positive benefit to the country should be carefully considered as the Committee considers changes in the Internal Revenue Code.

I hope these facts and perspectives have addressed your concerns. I will be more than happy to meet with you and other members of the Committee to provide additional information and answer any questions you may have.

Sincerely,

Michael L. Ainslie
President

The **CHAIRMAN**. Senator Long?

Senator **LONG**. No questions, Mr. Chairman.

The **CHAIRMAN**. Senator Grassley?

Senator **GRASSLEY**. I guess the thing that bothers me with this testimony—first of all, it doesn't bother me that you support the general thrust of the bill, but the extent to which, if all the exemptions are made, we haven't much left.

But, more important, except for the interest environment we are in, I am concerned about whether or not your groups would be taking advantage of the legislation that is now on the books, the extent to which you are, and whether or not, just because of that interest environment we are in, it's legitimate for the goals that you seek to be pursued that way.

Would each of you comment from that standpoint?

Mr. **LISSENDEN**. The MFOA's position is, first of all in the environment in which we are operating, that I think there is a misconception of how much interest break there is between taxable bonds and nontaxable bonds. Up until a month or so ago, taxable bonds were about 17 to 18 percent above the tax-free bonds. Today it has dropped back and the tax-frees are about 7.7, so the break isn't as large there. But our position is that this bill will hurt us in many other areas.

Most of us aren't even doing any of these things that are considered abuses, but, instead of that, we are going to have to pay more for our leasing computers, for our Xerox equipment, and that type of thing. We think that the language pertaining to the leases and such has to be cleaned up.

Senator **GRASSLEY**. Well, maybe my comments would be more appropriate to the preservation of things as you make use of them.

Mr. **AINSLIE**. Right.

I might respond in general by saying that the investment credits that were passed, and greatly strengthened in the ERTA in 1981, have made preservation a centerpiece of downtown revival and renewal in many of our cities.

The Brown Hotel in Louisville is being restored with an entire neighborhood, a $55 million project. Many of those buildings are owned by a tax-exempt entities. The school board happens to own the Brown Hotel. They are leasing it to a private developer.

That project would not be happening and in fact, may be undermined by this bill and the transition rules that are now proposed.

In these cases that we are testifying to make a case for an exemption, we are not talking about exempt organizations being the user; we are talking about reviving cities using historic buildings with private developers and ultimately commercial users, and those credits would be denied under this language.

Mr. **BELL**. We are talking about two different types of financing tools here; first is the tax-exempt financing. That is used not only because of the interest break rate but perhaps, even more importantly, because traditional conventional lenders are very often reluctant to make loans on large rehab projects in inner-city areas, particularly within their own communities.

The bond vehicle allows a developer that is looking to do a project to work with the municipality and go to a national capital market to obtain mortgage financing for the project.

Second, the tax credit is important because in rehab you have much greater front-end capital requirements than you do in other types of development. First of all, you are acquiring a piece of land that has a building on it, so it has a higher acquisition cost. Second, you have higher carrying costs during that period, because you need to insure that property; you need to make sure it doesn't deteriorate further. Third, you may have occupants in that property so services need to be maintained or else they need to be relocated. These are far greater front-end costs.

The CHAIRMAN. Excuse me, sir. Could you summarize your answer?

Mr. BELL. That's the answer.

The CHAIRMAN. We have nine more witnesses we need to hear. Is there any way you can lose as an investor with these generous credits we now have in the rehab program? We thought by lowering the 70 percent rate to 50 we would eliminate a lot of tax shelters, Instead, I read a story this morning in the Wall Street Journal that said tax shelters are investing dramatically.

I think, Mr. Ainslie, you have testified that a special exception be provided for the historic rehabilitation tax credit. I guess the question is, isn't that 25-percent credit the most serious problem? It's so generous now that you are just encouraging all kinds of tax shelters, more than any other area. I don't know who makes the money on the Willard Hotel, but I'll bet a lot of people are going to do very well on its restoration.

Mr. AINSLIE. Well, we have supported the credits, and the House and the Senate certainly agreed with that in 1981. They have had an enormous beneficial impact on preserving historic resources.

The CHAIRMAN. It also has been a big, big tax shelter for many people. It has been very lucrative, very generous—too generous, in my view, and it was my view in 1981 that it was too generous.

Mr. AINSLIE. They have accomplished a major objective of channeling private capital into historic resources, which Secretary Watt and the administration supported strongly in 1981 and continue to do so.

The CHAIRMAN. But, is that a rather lush tax shelter when you get into that kind of business?

Mr. AINSLIE. Well, I think Mr. Bell indicated there are risks and there are costs in rehab that are——

The CHAIRMAN. But what risk is there in a rehab project? That you might fall down, or something?

Mr. BELL. Well, there is the risk that you have a budget to work with and you find that exceptional circumstances put you far beyond that budget in the process. There are a lot of unknowns.

The CHAIRMAN. Can you think of anybody ever having lost money in one of these projects?

Mr. BELL. Oh, yes—personally.

Mr. AINSLIE. Yes, there are many.

The CHAIRMAN. But you are still sticking with it, as bad as it is. Well, it's the same area. If we start transition rules and making exceptions and exemptions, we won't have anything left. If we don't close the loophole, if there are loopholes—maybe there aren't; maybe they are just all provisions that we continue to cut the food stamp program so we can keep a program like this in action.

We are methodically discussing these provisions with members, and I would suggest if you get any action from your board prior to mid-September it might be helpful, because the House is now about ready to mark up their bill, as I understand, and I think it might be helpful if we had your indication.

Senator LONG. Could I ask a question, Mr. Chairman?

The CHAIRMAN. Sure.

Senator LONG. Mr. Lissenden, does the minimum tax now apply to state and municipal bonds?

Mr. LISSENDEN. No, sir, as it stands now. When we get into the social security tax on it, there will be a tax affecting it; but as of now it does not.

Senator LONG. Well, my recollection was that in the TEFRA bill we did agree to a proposal that puts the minimum tax on interest income from State and municipal bonds.

Mr. LISSENDEN. It was proposed, Senator, but I don't believe it passed. It was taken out, sir.

Senator LONG. Well, it had apparently been considered on the floor.

But that raises a point I had in mind. I completely applaud the chairman and his cosponsors in seeking to strike an abuse of the tax law.

There is an example where many of us agree that the Federal Government just should not undertake to tax the interest income on State and municipal bonds. We happen to believe that the *Pollock* case—it was Pollock against Farmers Loan & Trust Co., decided back in the previous century—is still correct in saying that the Federal Government has no right to tax a State government, and a State government has no right to tax the Federal Government.

Just the other day I noticed that the Supreme Court upheld the immunity of the Federal Government from State taxation, and somone wanted me to complain about that. I said,

> Not on your tintype; I'm not going to complain about that. I think that decision is correct, the State doesn't have a right to tax the Federal Government without its consent. And the Federal Government doesn't have the right to tax a State without its consent, or the city governments without the consent of the State or the government of which they are a part.

We can get into some very unfortunate situations by a rush to judgment, where we fire a blunderbuss at a problem rather than taking sufficient time to pinpoint what it is that needs to be corrected and what it is that should not be corrected.

You heard the testimony by Mr. Ainslie about historic preservation. Let me ask you if this is correct: You weren't getting anywhere with this until we started getting tax advantages for historic preservation. Is that correct, or not?

Mr. AINSLIE. It has helped enormously. We were not getting the private investment in historic buildings that we are now.

And I wanted to respond to Senator Dole. Last year about $1.1 billion of investment was stimulated, according to the Department of Interior statistics, by the historic credit. I am told the revenue loss on that was about $135 million.

I, for one, find the enormous impact in city after city that I visit, in terms of reviving their downtown communities to be far out of proportion in terms of its impact to that revenue loss. And I think the credits have, in fact, brought about a whole change in the way people are looking at their downtowns; they are bringing back investments.

Senator LONG. You can just go all over America and find areas where the people are just thrilled about the fact that they are able to save something of their history that otherwise would be gone.

I happen to know that that exists all over Louisiana. You referred to the old Willard Hotel over here. That is something that we will all be proud of if we can save that rather than tear it down. It will be something beautiful out of the past.

You were just testifying to the fact that you don't want us—and I trust your judgment on this matter—to go after this tax expenditure or a so-called tax shelter. You don't want us to proceed so rapidly toward judgment that we destroy something that is very good about our country. And I take it that that's what the panel of you are testifying to.

Mr. AINSLIE. Yes, sir.

Mr. LISSENDEN. Yes, sir.

Senator LONG. Well, I think that's correct. And may I say that I'm with the chairman on wanting to close any tax loophole where it is not justified and doesn't make good sense. I know how people can take advantage of tax loopholes. On the other hand, where we vote a legitimate tax advantage to do something very good for the country, I have my doubts that we ought to rush so fast to go after a tax loophole that would do more harm than good. That's the kind of thing that you people are testifying to, both on behalf of the cities and on behalf of the historic trust, I take it.

Mr. AINSLIE. Correct.

Senator LONG. Well, thank you very much.

The CHAIRMAN. Thank you very much.

Again, I am not in disagreement, but we have a big responsibility. We are told to raise $73 billion in new revenues. There are some who would just say, "Well, just take it away from the working people; raise their taxes or take away tax indexing."

It is my view, and I think it is shared by Senator Long and others, that we may have to, if push comes to shove, do some of those things. But before we do that, we had better make certain that somebody isn't making off with the store in the process.

Our next panel will be Jerome Joseph, Donald McLaren, and John Parker.

Senator GRASSLEY. Mr. Chairman, in regard to your last comment, I want to make it clear that my cosponsorship of this bill should not be interpreted in any way as an effort to raise $73 billion. [Laughter.]

I mean, from this one bill, or as a start of many other pieces of legislation.

Senator LONG. Well, I hope we are not planning to get the $73 billion from the cities and the historic trust. I don't think they've got that much. [Laughter.]

The CHAIRMAN. Well, we are told by Treasury and the Joint Committee we've got a loophole there that may be $10 to $12 billion.

Senator GRASSLEY. I look at this as a loophole-closing effort, and not as a foundation for building a bigger tax increase.

The CHAIRMAN. Well, the Congress passed the budget resolution—I didn't vote for it—that says we should do that, that it has no spending reduction in it. So some of us have mixed views.

Again I will say to the witnesses, your statements will be made part of the record. We hope that you might summarize your statements. We have had some discussion earlier on the matters that you have a direct interest in.

Let's see, Mr. Joseph, do you want to go first?

STATEMENT OF JEROME E. JOSEPH, VICE PRESIDENT, DISTRICT 2, MARINE ENGINEERS BENEFICIAL ASSOCIATION, ASSOCIATED MARITIME OFFICERS, BROOKLYN, N.Y.

Mr. JOSEPH. Thank you, Mr. Chairman.

Mr. Chairman, I am representing district 2 of the Marine Engineers Beneficial Association, which is a maritime union which represents seagoing merchant marine officers on approximately 200 U.S.-flag vessels which ply the ocean trade routes and the Great Lakes.

I appreciate the opportunity to appear before your committee and testify on S. 1564.

We are deeply concerned regarding the impact of 1564 on the maritime industry, including shipbuilding and ship coversion programs currently being carried on in a number of shipyards in the United States.

We are also concerned that S. 1564 will affectively preclude owners, operators, and charterers from pursuing maritime ventures which have been in use for several decades, where foreign corporations are the ultimate users of U.S.-flag vessels.

I'm not a tax expert, Mr. Chairman, and on many of the provisions of S. 1564 I am ignorant, even to include their attitude, their purpose, and effect. And I hope that I am the only one in the room that can make that statement.

However, it seems to me to be unfair and inequitable to change the rules of the game in midstream. For an example, the T-5's and the TAK-X programs, on which you heard testimony previously, every participant assumed that the full tax benefits of the Tax Code would be available for those projects.

As you know, the T-5 program involves the construction of five handy size tanker vessels, and the TAK-X program calls for the conversion or the construction of 13 special purpose roll-on/roll-off vessels which will be used by the Navy.

My organization has contracts to supply the officers for 15 of these 18 vessels; therefore, we are concerned that the passage of this bill will cause these projects to be canceled with the loss of some 900 seafaring jobs, of which approximately 225 jobs would be lost by our organization.

The T-5 and TAK-X programs are in existence, and some of the conversion and construction work is already underway, as you heard earlier. And we are anxious that these ventures not raise the tax benefits which were available at the time they were set up and contracted for.

The CHAIRMAN. Thank you very much.

Mr. McLaren.

[Mr. Joseph's prepared statement follows:]

TESTIMONY OF JEROME E. JOSEPH, VICE PRESIDENT, DEEP-SEA DISTRICT 2, MARINE ENGINEERS BENEFICIAL ASSOCIATION, ASSOCIATED MARITIME OFFICERS, AFL-CIO

Mr. Chairman, I am Jerome E. Joseph, Vice President, District 2, MEBA-AMO, a maritime union which represents sea-going merchant marine officers on approximately 200 United States flag vessels which ply the ocean trade routes and the Great Lakes. I appreciate the opportunity to appear before your Committee and testify on S.1564.

We are deeply concerned regarding the impact of S.1564 on shipbuilding and ship conversion programs currently being carried out in a number of shipyards in the United States. We are also concerned that S.1564 will effectively preclude owners, operators and charterers from pursuing maritime ventures which have been used for several decades, where foreign corporations are the ultimate users of U.S. flag vessels.

Mr. Chairman, I am not a tax expert and many of the provisions of S.1564 are a mystery to me. However, it seems unfair and inequitable to me to change the rules of the game in midstream. In the T-5 and TAK-X programs every bidder assumed that the full tax benefits of the tax code would be available for those projects. The T-5 program involved the construction of five handy size product carriers for the Navy, and the TAK-X project, calls for 13 special purpose roll-on/roll-off vessels to be built or converted for Navy. My Organization has contracts to man 15 of these 18 vessels, and I am concerned that the passage of this bill will cause these projects to be cancelled with the loss of some 900 American Seafaring jobs, of which 225 would be lost by members of District 2 MEBA-AMO.

The provisions of S.1564 would take away or substantially reduce currently available tax incentives, the accelerated cost recovery and the investment tax credit, with respect to the vessels to be chartered to the Navy under the T-5 and TAK-X programs. As previously discussed, the availability of these tax benefits under the present law were critical elements in the decision to proceed with these two Navy programs.

Section 2(a) of S.1564, would add a new paragraph 13, entitled "Property Used by Governments and Other Tax-Exempt Entities," to Subsection (f) of section 168 of the Internal Revenue Code of 1954. I am informed that the effect of this new section would be to take away or substantially reduce the availability of certain accelerated depreciation deductions from property used by a tax exempt entity, including the United States Government. Furthermore, it would appear to take away the availability of the investment tax credit with respect to certain contracts involving the United States Government which are considered to be service contracts.

Since the T-5 and TAK-X programs are in existence and certain of the conversion and construction work under those programs is already underway, we are particularly concerned that these programs not lose the tax benefits which were available at the time the programs were set up (and continue to be available under the current law).

Section 2(d)(1) of the bill entitled "Effective Date" provides that the amendments made by the bill apply to property placed in service by the taxpayer after May 23, 1983, in the taxable years ending after such date. Section 2(d)(2) provides, however, that the amendments made by the bill shall not apply with respect to any property used by a tax exempt entity if such use is pursuant to one or more written binding contracts which on May 23, 1983, and at all times thereafter, required -- (A) the taxpayer to acquire, construct, reconstruct, or rehabilitate such property, and (B) the tax exempt entity (or a related entity) to use such property, provided, however, in the case of property used by the United States, section 2(d)(2) shall apply "only if such property is placed in service by the taxpayer before January 1, 1984".

The vessels involved in the T-5 and TAK-X programs were not placed in service by the taxpayer by May 23, 1983. Furthermore, even though the vessels are apparently subject to written binding contracts which on May 23, 1983, and at all times thereafter, meet the requirements of (A) and (B) in section 2(d)(2), they will not be placed in service before January 1, 1984. The vessels involved in the current T-5 and TAK-X programs would lose their tax benefits under the proposed "Effective Date" provisions contained in section 2(d) of the bill.

For the reasons previously stated, it would be inequitable and grossly unfair to change these tax benefit rules after the private parties and the United States Government entered into these arrangments in good faith relying upon the availability of such benefits. We therefore urge that the effective date provisions of the bill be modified to "grandfather in" the contractual arrangements previously entered into with respect to the T-5 and TAK-X programs, and continue to permit the existing accelerated depreciation and investment tax credit benefits to be available with respect to the vessels involved in those projects.

Mr. Chairman, as I understand the bill, new subsection (f) of section 168, as added by section 2(a), would deny the benefits of accelerated depreciation if the property is to be used by any person who is not a United States person, and section 2(b)(1)A and B of the bill would similarly deny the benefits of the investment tax credit if the property is to be used by a non-U.S. person. Foreign companies have been the users of scores of vessels that fly the U.S. flag and were built in the United States. The Maritime Administration has encouraged such arrangments by providing the vessel operation with construction and operating subsidies and federal mortgage guarantees under Title XI of the Merchant Marine Act, 1936. The United States merchant marine is in a severe state of decline and operates with considerable disadvantages. We urge this Committee not to impose an additional burden on the U.S. maritime industry, by denying them the use of tax benefits where, as here, the shipping arrangement is totally commercial, merely because the ultimate user of the property is not a United States person.

Thank you very much.

STATEMENT OF DONALD McLAREN, VICE PRESIDENT, INTERNATIONAL AFFAIRS, THE BOEING CO., ROSSLYN, VA.

Mr. **McLaren**. Mr. Chairman and members of the committee, I am Donald McLaren. I am vice president of the Boeing Co. I have had some years of experience with international business, and with finance and contracts related to commercial airplanes.

We are concerned with the application of this bill to the leasing of airplanes to foreign airlines. The bill, if enacted in its present form, would do three things: One, we think it would cause Boeing to lose export sales in substantial volume. We think there would be a concomitant reduction in jobs for American workers throughout the United States, and we do think that the provisions would cause a net loss to the U.S. Treasury in tax revenues.

Investment tax leasing has been a practice in our industry for over 20 years. These are true leases we are talking about, and we do not think they are a tax abuse.

I would be glad to answer any questions on this.

The **Chairman**. Thank you.

[Mr. McLaren's prepared statement follows:]

STATEMENT OF DONALD McLAREN

Vice President - International Affairs, The Boeing Company

Before the Senate Finance Committee on S. 1564

July 19, 1983

Public agency leasing is the focus of S. 1564. The concern of The Boeing Company, however, is the effect of the bill on the export of new commercial airplanes.

United States investment tax credit (ITC) leasing to non-U.S. airlines has been an accepted practice in commercial airplane financing for over twenty years. The proposed bill as it relates to commercial airplanes would result in:

(1) A reduction in sales of commercial airplanes for use by non-U.S. airlines.

(2) A concomitant reduction in employment in the airplane manufacturing industry throughout the United States.

(3) A net revenue loss to the U.S. Treasury with respect to the financing transaction itself and with respect to the reduction in airplane sales.

We strongly urge that the provisions of S. 1564 relating to commercial airplanes be eliminated.

Reduction in Commercial Airplane Sales

Historically, foreign airlines have financed aircraft acquisitions either via debt financing or have obtained a lessor (a United States entity) who purchases the airplane and leases it to the airline. Typically the lessor will borrow 60 to 75% of the purchase price from another United States lender (this is the leverage) and put up the balance of the sales price (equity) himself. Since the lessor owns the airplane, he is entitled under current law to depreciate it and claim an investment tax credit. Because he obtains these tax benefits, he can pass on a lower lease rate to the lessee than would otherwise be possible. If the ability of the airline to lease and take advantage of the ITC is taken away, capital costs will increase. Hence, the acquisition of aircraft will not be nearly as feasible economically. The availability of investment capital at reasonable cost is a significant factor in an airline's decision to acquire new U.S. manufactured airplanes or to acquire used equipment. For example, currently there are over thirty 747s available on the used airplane market.

Current Sales

The majority of 747s are sold to foreign airlines. Seventy-one percent (71%) were exported between 1967-1982. In 1983 and beyond, 81% are expected to be sold to non-U.S. airlines. These customers rely heavily on access to U.S. lease markets. The tax effects impact the availability and terms of financing.

The importance of this type of financing is demonstrated by our current situation. There are currently fourteen 747s under firm contract with five non-U.S. airlines that are at various stages of arranging leverage lease financing with U.S. leasing companies. They are Japan Airlines (2), KLM (1), Singapore (7), SwissAir (3), and CAAC (General Administration of Civil Aviation of China - People's Republic of China) (1). The fourteen airplanes that will be delivered between now and the next two to three years have a total value of $1.2 billion.

Future Sales

These five non-U.S. carriers also have options for thirteen more 747s. It is highly likely they would also utilize ITC leasing on options that are exercised. Unfortunately some or all of these options may never be exercised if ITC leasing is not available.

We forecast that we will sell about three hundred 747s over the next ten years or an average of about thirty 747s per year. Based on recent experience, we would anticipate that about ten of these aircraft per year would be financed through an ITC lease, assuming that the foreign lease provisions of S. 1564 are not passed. If the bill is passed in its current form and ITC leasing is no longer available, we estimate that we could lose about three of the ten aircraft that would have been financed through the ITC lease. The foregoing does not take into consideration other airplane models which could meet ITC leasing requirements (Section 48 of the I.R.C.) For example, several Central and South American carriers have utilized ITC leasing in the past. There are $500 million potential near-term non-747 sales to these carriers.

In general, lesser developed countries (LDCs) are presently burdened with high debt service payments from heavy government borrowings. LDC governments cannot incur further debt to aid flag carriers in their acquisition of new airplanes. Leasing is necessary to place airplanes in these countries.

The initial purchase of new commercial jetliners by an airline is of extreme importance. The initial sale is typically followed by sales that total as much as three times the original commitment. Thus, the loss of that initial sale can effectively "shut out" a manufacturer from an airline's future orders for years, if not forever.

Beyond this consideration, it should be noted that a sale of any given model to a new customer can be the means of introducing that customer to some, if not all, of the other products of the manufacturer, or of convincing the customer to purchase such products in the future. The fact that such customers receive the economic benefits of commonality of equipment, crew training, spares, ground support equipment, etc., is a significant motivation in this regard.

Today, many of the world's airlines are facing major fleet modernization decisions and in the longer term we expect the total market to grow. We estimate that through the year 1995 the total market outside of the United States open to us and our competitors will be about $90 billion (in 1983 dollars). Some significant portion of this will be affected by the availability of ITC leasing.

In addition to the value of the airplane itself, each airplane sold will generate spare parts sales that total up to 3% of the purchase price each year of its life. At least one-third of the spares will be purchased from U.S. suppliers and exported to the world's airlines.

Reduction in Employment

It should be obvious that the loss of airplane sales will result in the loss of American jobs. A 1982 study by the Aerospace Industries Association concluded that in the commercial airplane industry, there are 13,400 direct jobs and 31,575 indirect jobs, a total of 44,975 jobs, dependent on each $1 billion in annual sales. At a sales price ranging up to $100 million dollars for a 747 and $40 - $60 million for 757/767 equipment, few sales can be lost before there is a dramatic effect on employment. Not only will Boeing hurt, but the many thousands of suppliers throughout almost all of the states will hurt as well.

Let us take the 747 as an example. The 747 airplane is assembled by Boeing in Everett, Washington. However, a 747 consists of 4.5 million parts. Seventy percent (70%) of its value is manufactured by first tier subcontractors and suppliers -- 1500 of them in 47 states. In addition, literally tens of thousands of lower tier suppliers, many of which are small businesses, also provide parts and equipment. This network of "invisible exporters", as we call them, extends into virtually every community across the economic fabric of the nation. The 747 is really an all-American product as shown below.

Avionics - Iowa
Nose - Kansas
Body - California
Tail - Texas
Landing Gear - Ohio
Major Wing Sections - New York, Maryland, Oklahoma, Ohio
Windshields - Pennsylvania
Engines - Connecticut and Ohio
Struts and Propulsion Pods - California

The fact that our 747 customers are raising the possibility of reducing the number of airplanes to be ordered in the future should be a concern to all of us.

Net Revenue Loss to U.S. Treasury

The proposed bill as it relates to commerical airplanes would result in a net revenue loss to the U.S. Treasury with respect to the financing transaction itself and with respect to the reduction in airplane sales.

The first part of the loss relates to the taxes on a U.S. lessor which will be lost if the lease occurs offshore. If the airplane is acquired by a non-U.S. airline using offshore financing there will be no tax revenue to the U.S. Treasury stemming from the financing transaction itself.

On the other hand, if the airplane is sold to a U.S. lessor and leased to a non-U.S. airline, the profit to the lessor over the life of the lease, including the book profit on the eventual sale of the airplane, is subject to U.S. income tax. The following analysis shows that there is a net gain to the U.S. Treasury under the current law which would be lost under the provisions of S. 1564:

	Tax Revenue for Leased Airplanes Under Current Law (Millions per Billion Investment) (Present Value at 10%)
Income Tax from Rental	$406 M
ITC Allowed	(100)
ACRS Allowed	(360)
Income Tax on Resale	60
Net Gain to Treasury	$ 6 M

The second part of the loss to the U.S. Treasury relates to the corporate and personal income tax lost because sales of new U.S. manufactured airplanes do not take place. Our analysis indicates that elimination of ITC lease financing will cause cancellation of new airplane orders of from 10% to 40% of estimated sales. For every $100 million of lost new commercial airplane sales, there will be a reduction of about $20 million in corporate and personal income taxes paid to the U.S. Treasury. When the impact of dependent indirect employment is considered, the amount would be about $60 million. If lost new commercial airplane sales run into the billions, the loss to the U.S. Treasury is staggering.

Conclusion

We strongly urge that the provisions of S. 1564 relating to the sale of commercial airplanes to non-U.S. airlines be eliminated. The provisions that affect commercial airplanes are neither in the interest of the U.S. Government, nor American industry, nor American workers and their families.

The CHAIRMAN. Mr. Parker.

STATEMENT OF JOHN H. PARKER, VICE PRESIDENT AND GENERAL COUNSEL, CTI-CONTAINER TRANSPORT INTERNATIONAL, INC., WHITE PLAINS, N.Y.

Mr. PARKER. Mr. Dole, I am here on behalf of CTI-Container Transport International Inc., a company that is engaged in the leasing of marine cargo containers primarily to shipping companies.

We are here to testify in opposition to and to request changes to be made in proposed S. 1564 to delete the reference in the definition of tax-exempt entity to any person who is not a U.S. person. We feel that the effect of this provision would be to effectively limit the taking of ACRS and ITC to a company such as CTI, which is engaged in the pure leasing business.

Alternatively, we would propose that an exception be drafted to S. 1564, carving out the 11 items of property set forth in present section 48(A)(2)(B) of the Code, thereby allowing owner-lessors to continue to take ITC and ACRS.

We feel that if S. 1564 is enacted as drafted, that it will force the expatriation of U.S. companies, as they will no longer see any economic benefit or incentive to remain in this country.

Lastly, Senator, we would point out that we feel that there is an inconsistency between present S. 1564 and the provisions of the U.S. double taxation treaty policy, and that S. 1564, as drafted, denies the favored nation status to countries covered by double taxation treaties.

Thank you.

[Mr. Parker's prepared statement follows:]

MEMORANDUM OF CTI-CONTAINER TRANSPORT INTERNATIONAL, INC. IN OPPOSITION TO SENATE BILL 1564, GOVERNMENTAL LEASE FINANCE REFORM ACT OF 1983

CTI-Container Transport International, Inc. (hereafter "CTI") submits this memorandum in opposition to S1564 entitled "Governmental Lease Financing Reform Act of 1983" (hereafter referred to S1564) and to suggest certain modifications to be made thereto.

CTI is engaged primarily in worldwide leasing of marine cargo containers to the transportation industry, primarily to ocean carriers, the vast majority of which are not United States persons. CTI believes it is the largest lessor of marine cargo containers in the world and together with other American container leasing companies own 1.2 of the world's 4.2 million twenty foot equivalent units ("TEU") of containers, which are available for lease.

CTI leases its containers fro periods ranging from several days to five (5) years. All lessee charges under CTI's leases are payable in United States Dollars, thereby helping the balance of payments to the United States.

As a result of the short duration of CTI's leases, which is true of the container leasing industry in general, and due to the fact that the majority of steamship companies to whom container leasing companies lease are not United States persons, S1564 will have a drastic impact on American container leasing companies.

Impact of the proposed legislation on CTI and on leasing companies doing business with non-United States persons

If passed, S1564 would deny the use of the accelerated cost recovery system (ACRS) to container leasing companies, and to leasing companies in general, if they lease to a person who is not a United States person and the term of the lease exceeds 75% of the class life of the leased property. In the case of a container, the class life is six (6) years, thereby limiting the lease term, if ACRS is to be claimed, to 4.5 years. S1564 will also deny investment tax credit (ITC) to the owner-lessor if the lease is to a person who is not a United States person unless the lease term is less than 30% the class life of the property. In the case of a container, the lease term would be limited to 1.8 years or the owner-lessor cannot claim ITC.

In short, S1564, if enacted, will place constraints on leasing companies, the effect of which will make them non-competitive with foreign leasing companies.

It is ironic to note that ITC was originally placed in the Internal Revenue Code in order to encourage the infusion of capital into American companies in order to make them competitive with foreign companies, as well as to build American industry. Specifically, the legislative history of ITC leads one to the conclusion that Congress had capital intensive companies in mind when enacting the law permitting

ITC and it is clearly the case that a leasing company is a capital intensive company. The loss of ITC together with ACRS will, therefore, have an adverse economic impact on United States leasing companies and especially the container leasing industry. If ITC will be denied in the purchase price of the very item with which a company conducts its business the economic impact is obvious. Moreover, if the company will also be denied ACRS on such property, then the question must be asked as to whether such companies will be able to remain in business.

Recommended Modification to S1564

In view of the adverse impact proposed S1564 will have, CTI proposes the following modification thereto.

First, CTI recommends S1564 be modified by the deletion of the reference to any person who "(I) is not a United States person, or" (proposed Section 168(f)(13)(E)(iii)(I)), as well as the deletion of the reference to a person who "(i) is not a United States person, or" (proposed Section 48(a)(5)(B)(i)). Such a modification would continue to permit United States companies to lease to non-United States citizens and obtain the benefits of ACRS and ITC while denying the right to lease to other "tax exempt" entities, as defined in S1564, and continue to obtain the benefit of ACRS and ITC.

Secondly, CTI recommends that if the definition of "Tax Exempt Entity" will remain as drafted, then an exception should be drafted which specifically exempts from the provision of this legislation the eleven (11) items of international trade and telecommunications specified in Section 48(A)(2)(B) of Internal Revenue Code of 1954, as amended, thereby allowing the owners of such property to continue to obtain the benefits of ACRS and ITC notwithstanding to whom the property is leased.

CTI respectfully submits that the eleven (11) cases set forth in Section 48(a)(2)(B) dealing with international transportation and telecommunication items for which ITC can be claimed were carefully considered items by the legislature that adopted the same. For this Congress to pass legislation without further study and consideration as to what the effect will be on United States trade, on the balance of payments, the loss of jobs and shrinkage of the market-place is irresponsible.

If the proposed legislation is passed without any of the modifications suggested herein, one result will be to force the expatriation of United States companies. Companies, such as CTI, will be forced to consider whether it is economically feasible, or desirable, to continue to be a United States corporation or whether to move the corporation off-shore. Clearly, this is not a desirable result to the United States. Such a move would affect the balance of payments to the

United States and would result in the loss of jobs to United States citizens, together with an eventual loss of tax revenues to the United States government.

The proposed legislation also raises serious issues with respect to its effect on United States double taxation policy and would tend to destroy the effect of such policy. For example, under the Treasury Department's Model Double Taxation Treaty and under double taxation treaties negotiated with a number of principal trading partners, the United States has granted exemption from taxation to foreign ship lines in exchange for the reciprocal concession on the part of the foreign country of exemption from taxation of United States ship lines (the Treasury Department Model Treaty also includes reciprocal treatment for container leasing companies).

If the provisions of S1564 are applicable to leases of containers to foreign ship lines which are exempt from United States taxes by treaty and is also applicable to leases to ship lines of non-treaty countries 20% of whose income is not subject to United States taxation, a number of problems result. First, leasing to a ship line from a country covered by a double taxation treaty, supposedly a "favored" nation, will result in loss of ITC and ACRS benefits, except as provided in S1564.

Second, even if the first lease of the containers is to a ship line who pays tax on 21% of its income to the United States or to a United States company, the prospect of subsequent leases to ship lines from treaty countries to ship lines or 20% of whose income is not subject to United States taxation would raise the issue of whether the ITC and ACRS benefits would have to be foregone in most or all leases anyway. There would almost certainly be a lease to a ship line from a treaty nation or a non-United States tax paying ship line at some point in the container's life. Moreover, a decision whether to take the ITC must be made in the first year's tax return, which will occur before the nationality of all lessees in the container's subsequent lease history will become known.

During the hearings on a similar piece of legislation introduced by Congressman Pickle, H.R.3110, the Treasury Department, in its testimony, noted a similar problem with regard to the Pickle legislation and recommended that the provision therein relating to "any person who is not a United States person" be dropped from the proposed legislation pending further study of the same. CTI recommends that the Senate Finance Committee also delete the reference to any person who is "not a United States person" pending a more comprehensive review of the impact of the proposed legislation and the effect the same will have on the American economy.

S1564, as drafted, is intended to stop certain abuses from continuing to take place. However, by attempting to amend the provisions of the Internal Revenue Code which are being abused, S1564 goes too far and impacts on numerous American industries in a fashion clearly not contemplated at the time of the drafting of the legislation. Accordingly, CTI strongly urges the Senate Finance Committee to adopt either modification set forth herein pending a comprehensive and systematic study of the economic impact of S1564 prior to enacting the same in its present form in order to ascertain what the consequences would be.

The **Chairman**. Senator Long.

Senator **Long**. No questions.

The **Chairman**. Senator Grassley.

Senator **Grassley**. No questions.

The **Chairman**. Senator Boren.

Senator **Boren**. No questions.

The **Chairman**. Well, I think we did note in my statement introducing this bill that there was a problem here that needed to be addressed, and you may have touched on another one—we will be looking at that.

I think we also probably can satisfy the concerns you expressed, Mr. Joseph. So we will be working with you and your counterparts as we go through the markup sessions.

The House, as I understand, will act very soon.

We appreciate your testimony, and your entire statements will be made a part of the record.

Thank you.

Mr. **Parker**. Thank you.

The **Chairman**. Our final panel: Fred Rafanello, president, Financial Investment Associates; John Booth, project director, Bi-State Development Authority, St. Louis, Mo., on behalf of the National Resource Recovery Association, an affiliate of the U.S. Conference of Mayors; John Kehoe, senior vice president for business development, Signal-Rescoo, Des Plaines, Ill., on behalf of the National Solid Waste Management Association; Steven H. Hanke, adjunct scholar, Heritage Foundation; and Delmar Banner, president of the Farm Credit Council, Washington, D.C.

Let's see, Fred, do you want to go first?

Mr. **Raffanello**. Yes, Mr. Chairman.

The **Chairman**. Again, I would indicate to the panel that your entire statements will be made a part of the record. We are pleased to have you here.

STATEMENT OF FRED RAFANELLO, PRESIDENT, FINANCIAL INVESTMENT ASSOCIATES, NORTHFIELD, ILL.

Mr. **Rafanello**. Mr. Chairman, we appreciate your concern expressed for leasing of hospital diagnostic equipment. The bill, though, in its present form, would disrupt this equipment market and indeed threatens the existence of the hospital equipment leasing industry.

True lease financing of new hospital equipment does not involve the abuses presented today. There is no investment tax credit; there is no tax-exempt debt; and there is no avoidance of accountability.

Prior to ACRS, hospital equipment was depreciated over 5 years, using double-declining balance. This depreciation schedule closely approximated the true economic depreciation of most hospital equipment and was upheld on audit.

ACRS treats hospital equipment less favorably than prior law.

Senate bill 1654 should provide for true economic depreciation of hospital equipment as provided for by facts and circumstances, or ACRS.

Thank you.

[The prepared statement follows:]

WRITTEN STATEMENT OF FRED V. RAFANELLO, PRESIDENT, FINANCIAL INVESTMENT ASSOCIATES INCORPORATED

Financial Investment Associates Incorporated (FIA) appreciates the opportunity to submit this testimony on S. 1564, the Governmental Lease Financing Reform Act of 1983. For a number of years -- beginning well before the advent of the ACRS system -- FIA has leased sophisticated medical diagnostic and treatment equipment to hospitals, and also has structured tax advantaged limited partnerships which lease such equipment to hospitals.

Unless amended, S. 1564 would gravely threaten the ability of hospitals to continue their long-standing practice of leasing short-lived, high technology equipment. We urge that an appropriate amendment be adopted to remedy this problem, because:

-- the leasing of hospital equipment does not involve the abuses that the bill is intended to prevent;

-- the bill would have the unintended effect of significantly and unnecessarily increasing health care costs; and

-- the bill would treat high technology hospital equipment in an unfairly different way from other equipment by prescribing a rate of depreciation that is significantly slower than the actual economic decline in value of the equipment involved.

I.

First, it is important to contrast the long-standing practice of leasing high technology hospital equipment with the kinds of post-ACRS activities at which S. 1564 is directed. Materials before this Committee have shown numerous instances of the pyramiding of tax incentives, in which tax-exempt entities have obtained the benefits of accelerated depreciation and investment tax credits (ITCs) and tax-exempt financing with respect to the same property, or have engaged in sale-leaseback transactions of used property. In other cases, a concern has been expressed that leasing to federal agencies has risked circumvention of the appropriations process.

I can assure this Committee that none of these instances involves hospital equipment; and I would like to explain why. Eighty-five to ninety percent of all hospitals in this country are either tax-exempt not-for-profit institutions or government hospitals. Thus, equipment purchased by or leased to such hospitals is not eligible for the investment tax credit; and, since the equipment is not subject to "service contracts," the investment credit is not available indirectly for such equipment, either.

While hospital equipment is sometimes financed by tax-exempt bonds, such financing is treated as an alternative to, and not in addition to, leasing; in fact, leasing and tax-exempt bonds are competing forms of financing for hospital equipment. Nor are sale-leasebacks of used property involved; the equipment is new property that the hospitals need to acquire -- with a short life and a high risk of rapid obsolescence -- rather than the kinds of used property that some institutions have been refinancing through sale-leasebacks. Finally, the leasing of hospital equipment is not used to avoid accountability; if a Certificate of Need is required for the purchase of a particular item of equipment, it is also required for the lease of such equipment. Thus, the leasing of hospital equipment clearly does not involve the perceived problems associated with the types of transactions at which S. 1564 is directed.

II.

Second, enactment of S. 1564 in its present form would significantly and unnecessarily raise health care costs. If the nine-year straight-line depreciation schedule of the bill were enacted, the cost to not-for-profit and governmental hospitals of leasing high-technology equipment would be increased by 15 percent or more, while the rates paid by proprietary hospitals would remain the same. This, in turn, would lead to an increase in health care costs for hospital patients, particularly for the poor and elderly who are more likely to use not-for-profit and government hospitals. Yet, such a result is neither intended nor necessary in order to achieve the goals of S. 1564.

In short, hospitals working to control costs have found leasing to be a needed and useful tool in appropriate situations. S. 1564, in its present form, would deny them this cost-effective financing option.

III.

Finally, and perhaps most importantly, S. 1564 -- which is intended essentially for long-lived property having depreciation which was accelerated by ACRS -- is not appropriate when applied to short-lived property such as high technology hospital equipment, the depreciation of which was actually slowed by ACRS. In its present form, S. 1564 would require property leased to tax-exempt entities to be depreciated on a straight-line basis over a period equal to its ADR class life. High technology hospital equipment, however, never had an appropriate ADR class, but was included in a catch-all class (57.0) for all "Distributive Trades and Services." That class includes "assets used in wholesale and retail trade, and personal and professional service," and has a guideline period of nine years (with an optional seven-year low point). This guideline period is unrealistic when applied to high technology hospital equipment, for a number of reasons. Such equipment customarily embodies the latest advances in constantly changing medical and computer technology and is subject to the significant risk of early obsolescence. Indeed, it is often the problem of obsolescence which leads hospitals to lease instead of purchase, thus shifting this risk substantially to private investors. The equipment is used constantly by numerous hospital personnel, in around-the-clock shifts. The wear and tear caused by such use, the rapidly increasing servicing costs, and the increasing down-time combine to reduce the value of the equipment over a relatively short period.

Since the ADR class was inappropriate for hospital equipment, prior to ACRS taxpayers consistently depreciated such equipment over five years using the double declining balance method with a 15 or 20 percent salvage value, under the "facts and circumstances" test, as then allowed. Such depreciation treatment was repeatedly upheld on audit.

The Treasury Department, in its testimony before the House Ways and Means Committee on June 8, 1983, called for the depreciation of leased equipment to be based upon "one criterion consistently, economic depreciation or prior law." In the case of high technology hospital equipment, economic depreciation is very close to the depreciation allowed under prior law -- that is, double declining balance over five years with recognition of modest salvage value. S. 1564 as presently drafted would allow depreciation less than half that fast, and therefore would inequitably depart from its own premise that property leased to tax-exempt organizations should at least be allowed true economic depreciation.

Conclusion

For the reasons set out above, we believe the purposes of S. 1564, together with other important policy goals, would best be served by excluding from its coverage the leasing of short-lived, high technology hospital equipment. An exclusion for such equipment would permit continued application of the ACRS recovery rates, which are themselves somewhat conservative in light of the very rapid obsolescence of the type of equipment involved.

Accordingly, we urge that for leases with a duration of 5 years or less of qualifying high technology equipment, the bill be amended to require the continued application of existing law. An appropriate definition of qualifying high technology equipment would be: "Electronic, electromechanical and computer-based equipment used in the screening, monitoring, observation, diagnosis and treatment of patients in a laboratory, medical or hospital environment."

We appreciate greatly the opportunity to testify before the Committee on this important matter.

The CHAIRMAN. I wanted to say we are looking at your statement because this is an area that we think should be addressed. If they are not tax motivated, it may be an area that we should discuss further with you, and we will be discussing it with you; but it has been flagged by the staff in advance of your testimony, and we appreciate your statement.

Mr. Booth?

STATEMENT OF JOHN BOOTH, PROJECT DIRECTOR, BI-STATE DEVELOPMENT AUTHORITY, ST. LOUIS, MO., ON BEHALF OF NATIONAL RESOURCE RECOVERY ASSOCIATION, AN AFFILIATE OF THE U.S. CONFERENCE OF MAYORS, WASHINGTON, D.C.

Mr. BOOTH. Thank you, Senator.

I am John Booth, general manager of development for the Bi-State Development Agency, which is a public corporation in St. Louis that is responsible for developing research recovery, waste-to-energy projects, and district heating systems in the St. Louis area.

I am representing the National Resource Recovery Association, which is a group of 150 cities and private firms developing these waste-to-energy projects throughout the country at this time.

I will try to make my remarks brief and to the point. My testimony, I'm sure you will have an opportunity to read.

In summary, we feel that this particular bill threatens the viability of traditional resource recovery arrangements by applying criteria which are vague and somewhat restrictive regarding Government economic and possessory interest.

Resource recovery projects, by their very nature, require public/private sector involvement, and these are projects which over their 10-year history do not depend on what I would call loophole tax financing.

In addition, the criteria are not all-inclusive, leaving an entirely open-ended set of criteria unknown to us, to the committee, and to the cities that are presently trying to finance these most difficult projects.

We feel the bill would also undermine the policy decision made in TEFRA that the use of tax benefits should be continued for municipal solid waste disposal facilities. Because of this uncertainty, the net effect of Senate bill 1564 on solid waste disposal facilities would be to halt or undermine many resource recovery projects; to drive private investors away from these projects; to increase tipping fees paid by the municipalities up to 75 percent; to weaken the negotiating hand of the public sector that is trying to negotiate these contracts, which are based on hard bargaining decisions; to discourage the expedient replacement of overcrowded and polluting landfills; and, finally, to discourage a national policy that makes possible public-private arrangements in the resource recovery development.

Thank you, Senator.

The CHAIRMAN. Right. I would just say to you and Mr. Kehoe, we don't think you are covered by our bill, but we are glad to have you here. If you would like us to take another look at it, we will.

[Mr. Booth's prepared statement follows:]

Testimony Before the United States Senate Finance Committee

by the

U.S. Conference of Mayors
National Resource Recovery Association

Tuesday, July 19, 1983

Mr. Chairman, I am John Booth, Project Director for Bi-State Development Authority in St. Louis, Missouri, representing today the National Resource Recovery Association, an affiliate of the U.S. Conference of Mayors. Bi-State is a public authority which is responsible for developing for the City of St. Louis a 600 ton per day facility. The NRRA is a group of over 150 local jurisdictions and private firms which are in the process of developing waste-to-energy projects and district heating and cooling facilities. These facilities represent urban America's major energy and waste disposal infrastructures. We are very concerned about the negative effects S.1564 would have on project development across the country.

Urban-waste-to-energy projects represent our nation's major alternative to landfills for the disposal of municipal refuse. The United States generates over 150 million tons of garbage annually and it is essential that local governments develop with the private sector alternative means for disposal before our groundwater is further polluted. Currently, about 50 jurisdictions have operating resource recovery facilities, another 50 are actively developing projects, and 100 more are in initial planning.

S. 1564 was precipitated by certain sale-leaseback and other arrangements that have come to the Committee's attention. However, the actual provisions of the bill will go far beyond that and undermine many worthwhile public/private projects, especially in the resource recovery field. We are here to let the Committee know about these adverse affects.

Typically, in a large-scale municipal waste-to-energy facility, a private vendor or owner enters into a service contract arrangement with participating local governments. In exchange for the localities' commitment to deliver their solid waste to the facility, and sometimes to buy steam, the private owner promises to provide an important waste disposal service in an efficient and environmentally safe manner. These arrangements are subject to hard bargaining, and the private participant undertakes significant financial commitments and incurs real risks. These private sector risks include guarantees to construct the facility within certain cost parameters and in a timely fashion; to successfully test the technology and keep the facility open and functioning; and to attract other private and public solid waste and steam or electricity customers. These facilities remain under the operation and control of private parties.

The private sector has been involved with cities in resource recovery projects for at least ten years in the U.S. The private sector ownership of resource recovery facilities brings specialized expertise to bear, and relieves cities of significant risks. The existence of tax benefits provides a basis for the private sector to be involved in these projects and shifts a substantial portion of the capital cost from public sector financing to private sector equity contributions. All these benefits of traditional private sector involvement help financially strapped cities to lessen their dependence on scarce landfill space and develop infrastructures that create jobs and economic growth.

S. 1564 threatens the viability of these traditional resource recovery arrangements. Present law already prohibits the application of the Investment Tax Credit where property is "used" by government. However, the IRS and the courts have recognized an exception for service contracts, where private firms provide services to tax-exempt organizations versus a lease wherein the tax-exempt entity provides a service to itself. The service contract/lease distinction developed under Section 48(a) (4) and (5) is so unclear that cities must incur exorbitant expenses for legal services and suffer delays in resource recovery construction.

S 1564 attempts to codify the relevant criteria for making the service contract/lease distinction. In fact, the bill's language will jeopardize the ability for these projects to qualify as service contracts and will exacerbate the present situation. First, the stated criteria, particularly the limitation on government economic and possessory interest in the property, are vague and restrictive. These criteria would appear to prohibit the traditional arrangements entered into in these projects. Second, by directing the Secretary of Treasury to take into account all relevant factors, of which the stated criteria are not all inclusive, the provision in effect hands this matter over to the Secretary to draft regulations. These regulations could establish tests reflecting the Treasury's weighing of the relevant factors that may be totally unknown to cities that must begin to develop projects now. Under such circumstances, bond counsel will now be unable to provide an opinion on the status of projects under this law. Therefore, this bill jeopardizes the usefulness of service contracts and forces cities to engage in time consuming and expensive legal rulings. This situation is unacceptable in the face of the mounting solid waste crisis. Mr. Chairman, a transitional rule will not solve this problem. We are concerned about the long-term furture of this basic infrastructure.

Last year Congress considered at length continued use of tax benefits for municipal solid waste disposal facilities. TEFRA contains a clear mandate for federal tax policy to encourage this type of development. S. 1564 would undermine this policy decision. We in the field thought that this issue had been put to rest last summer and we have planned accordingly. It would be unfair to change the rules on us again.

The effect of this bill would be to drive private investors away from resource recovery projects. The restrictions within S 1564 would simply stop equity investments. As a consequence, preliminary NRRA calculations show that tipping fees (what a city must pay to dispose of its trash) will increase tremendously, on the order of 75%. The size of bond issues will have to be increased dramatically. The fact is, Mr. Chairman, this magnitude of unprecedented cost increases will halt many projects and will contribute to the futher deterioration of urban infrastructure. Many municipalities will be forced to continue to dump their trash at overcrowded and polluting landfills. In other cases, in order to comply with these new restrictions, cities will be forced to relinquish all contractual control over the operation and services provided by these facilities, undermining their ability to ensure adequate garbage disposal services. Cities will be unable to negotiate with the private sector to require proper operation of the facility and delivery of services. We believe that the sponsors of S. 1564 do not intend this major redirection of national policy on resource recovery to occur.

In Summary, this legislation will:

1) Halt or undermine many resource recovery projects.

2) Add uncertainty to the tax code that will weaken the public sector's ability to negotiate fair contracts with the private sector.

3) Increase development and legal costs that already are staggering for local governments.

4) Shift national policy to discourage resource recovery development and the private sector's traditional role in public projects.

Mr. Chairman, we thank you for the opportunity to testify. It is essential that waste-to-energy be protected from the potential crippling effect of this bill.

STATEMENT OF JOHN KEHOE, SENIOR VICE PRESIDENT FOR BUSINESS DEVELOPMENT, SIGNAL-RESCO, DES PLAINES, ILL., ON BEHALF OF THE NATIONAL SOLID WASTES MANAGEMENT ASSOCIATION, WASHINGTON, D.C.

Mr. **Kehoe**. Mr. Chairman and members of the committee, my name is John Kehoe. I am the senior vice president with Signal-Resco. Signal-Resco represents the merged capabilities of the UOP Solid Waste Division and the Wheelabrator-Frye Energy Systems Division.

I am testifying today on behalf of the National Solid Wastes Management Association's Institute of Resource Recovery.

The Congress in 1981 recognized the efficiency and environmental advantage of resource recovery, a technology that converts waste to energy. NSWMA asked the Congress to continue their support.

Municipalities having landfill problems often turn to resource recovery. Communities are interested in guarantees that the system will work technically and reliability. They want the builder-operator to take project risks.

The reason for private participation is clear: Financing using private capital allows lower prices and provides the incentive to make the project work. Enactment of Senate bill 1654 could bring this activity to a halt, the participation of private capital in future projects.

Resource recovery provides an essential public purpose. We only ask for the continuation of the tax incentives that are available to attract private capital to other industries.

Disposal fees are a primary source of revenue for resource recovery, but the plant must compete with existing landfill operations. Energy revenues from these plants lower disposable fees over the life of the facility; however, because of high financing costs, disposal fees for the first few years still remain significantly higher than landfill.

Most communities have a major political problem in dealing with these high front-end fees. The Congress has provided tax incentives for capital investment which, when applied to resource recovery, attract capital from the private sector, and thus make resource recovery competitive with landfill.

Investment of private capital reduces total amount financed on currently lowest disposal fees to the public. The private investment also introduces significant elements of risk-sharing between public and private sectors. Over the past 2 years, we have seen significant movement in financing and construction of resource recovery projects. Tax incentives have been a significant factor in four out of five major projects financed in the last 2 years.

We recommend that the exemption for resource recovery bc continued.

Thank you.

The **Chairman**. Well, again, as I said to Mr. Booth, I don't think you are covered by our bill, but we are happy to have you here, and your statement is on the record. We will be looking at it.

Mr. Hanke?

[Mr. Kehoe's prepared statement follows:]

PREPARED STATEMENT OF JOHN KEHOE, SENIOR VICE PRESIDENT FOR BUSINESS DEVELOPMENT, SIGNAL-RESCO, INC.

Good morning Mr. Chairman and members of the Committee. My name is John Kehoe, Vice President of SIGNAL-RESCO INCORPORATED, Des Plaines, Illinois. I am speaking on behalf of NSWMA's Institute of Resource Recovery. Our members provide waste collection and landfill disposal services. They also provide complete resource recovery services including systems design, construction and operation. All these systems can help meet the national need for environmentally safe waste disposal and energy development.

Communities have two basic choices in refuse disposal: either bury it in the land or burn it. Where economics allow, disposal by resource recovery with energy recovery best serves the public purpose intended by Congress. Restrictions on the use of tax incentives as proposed by S. 1564 would discourage the continued development of resource recovery.

Last year we provided testimony to this Committee demonstrating that financing waste-to-energy projects through private sector participation significantly lowers the overall costs to communities. At that time we believed elimination of tax incentives to attract private investors to participate in these projects was a bad idea. The Congress agreed that these projects indeed served an essential public purpose and exempted solid waste disposal facilities from restrictions placed on industrial development bonds through the Tax Equity and Fiscal Responsbility Act (TEFRA) of 1982.

We are aware of your concerns with respect to abuses of tax incentives and come to you today to report our experience of the past twelve months. Your judgment of last year was sound. We have seen five projects financed using the special provisions provided and intended for use by the Congress.

Municipalities want and need reliable solid waste disposal facilities at competitive costs. Attaining this competitive posture requires private sector participation. These projects have all been financed in a responsible manner and it is our judgment that municipalities will continue to do so in the future. It is our further judgment, backed by our track record, that solid waste disposal facilities should be clearly excluded from S. 1564, and exclusion which reflects a continuation of the intent Congress expressed last year.

The public purpose of the solid waste disposal provisions which you crafted is being achieved. We perceive this purpose to be:

First, the commitment expressed by Subtitle D of RCRA in 1976 to provide for environmentally sound solid waste disposal facilities and; second, the commitment expressed by the Energy Security Act of 1978 to seek energy independence. Prompted by these initiatives, we are now seeing a definite move at the state and local levels to develop adequate facilities for disposal of solid waste. Currently, more than two hundred communities are planning waste-to-energy projects which will help solve their disposal problems and provide for an energy component to help off-set disposal costs. Approximately twenty major projects are under construction or in operation. At least a dozen more are approaching the contractor selection and financing stage. The continued availability of tax incentives for resource recovery, the policy clearly emphasized by this Committee and the Congress last year, will continue the progress currently being made in this field.

Solid waste disposal facilities today represent a unique partnership between the private sector and the public sector at the local, state and federal levels. Let me explain this relationship because it is key to why I am here today.

The local community has a responsibility to ensure that solid waste disposal occurs in an environmentally safe and cost effective manner. The environmental standards are established by state and federal regulatory agencies. However, about three-fourths of all refuse collection is performed by the private sector. Both collection and disposal costs are increasing due to rising energy prices for transportation and rising construction costs to make landfills environmentally safe. Today, private companies are usually able to finance landfill site acquisition and construction costs. This is not true for major resource recovery facilities whose costs can approach $250 million.

Rising costs and the inability to find long-term environmentally safe areas for landfill within their boundaries have moved many communities to examine disposal alternatives which may be economical in the long run. Most alternatives being examined today center around a waste-to-energy facility of some type. The facilities now being examined and built have the objective of reliable day-in, day-out disposal of solid waste. Financing these facilities, however, has proven to be difficult.

Communities have three generally available alternatives to financing a project: General obligation bonds; industrial development bonds; or industrial development bonds with private sector participation. Two communities have financed their facilities, one about three years ago and one recently, using revenue bonds with no private sector participation. Four others have selected and obtained private sector participants. It is this ability to choose from a variety of financing alternatives that must be retained for municipality use.

One of the options available to local governments in the development of resource recovery would be government ownership of facilities. One-hundred percent of the capital cost is financed with tax-exempt bonds. To the extent that resource recovery is developed on such a basis, the revenues derived from the facility are entirely exempt from federal income tax. This method of ownership and financing has not found wide appeal for a variety of reasons.

The marketplace demonstrates that resource recovery facilities require the participation of private industry if they are to be constructed and operated on the basis of a disposal fee that makes them competitive with existing landfill costs. In fact, the combination of public and private sector cooperation in the development of these facilities is the cornerstone for their successful development, and any change in the present financing and tax benefits available for these facilities will be a great detriment to this cooperation.

I would like to point out that the four projects (Westchester County, New York; Baltimore County, Maryland; North Andover, Massachusetts; and Lawrence and Haverhill, Massachusetts) have other very definite public purpose fall-outs in which the private sector plays a part. First, the developer, the operator and the equity participant all have a large interest in making the project work. This interest was absent in several previous and on-going waste-to-energy projects with very unfortunate results. The private partner's interest assures the community needing the service that the project will dispose of their garbage reliably and in an environmentally safe manner. There is one entity responsible to the community for the project.

Second, tax incentives that are available to attract private capital to other industries represent the minimum appropriate federal commitment to resource recovery. This commitment achieves the twin objectives of encouraging effective treatment and disposal of solid waste and recovery of energy, longstanding Congressional objectives.

Please recall that we vigorously opposed and continue to oppose the use of federal grants, loan guarantees, price support loans and other similar subsidies to assist resource recovery projects. We believe they encourage and reward adventurers who competed for projects against legitimate private-sector corporations possessing the technical and financial basis to complete a project and make it work. Communities also contributed to the problem by lining up, hoping for federal funds and delaying the solving of their solid waste problems. We are pleased that these programs are for the most part unfunded by Congress.

Resource recovery projects are self-limiting. They will only be built where there is a solid waste disposal problem. The energy recovery portion simply reduces the disposal costs and in the long run can make them economical for the community. The existence of tax incentives that are normally available for capitol investment by private enterprise will not distort the marketplace for those projects.

I would like to make one last point. These projects create new jobs. It typically takes 3-4 years to build and place into operation a waste-to-energy facility. The construction contractor will employ up to 1000 workers during this period. When completed, these facilities will employ 60-70 full-time staff. The project returns taxes to the Treasury as soon as construction begins. Resource recovery facilities still require a landfill (with its employees) for residue and shutdown periods as well as all of the collection personnel, both private sector or public sector, to bring the refuse to the facility.

We believe that elimination of existing tax incentives would be a severe setback for municipalities attempting to make environmentally desirable choices about waste disposal.

On behalf of NSWMA, I want to thank the Committee for the opportunity to present the statement.

STATEMENT OF STEVEN H. HANKE, SENIOR FELLOW, HERITAGE FOUNDATION, WASHINGTON, D.C.

Mr. **Hanke**. Mr. Chairman, it is a pleasure to be here.

Mr. Chairman, since we have somewhat differing views on the bill before you, I will just summarize my differences very briefly.

I believe tax-exempt leasing is desirable, and the four desirable consequences associated with tax-exempt leasing are:

First, I believe federalism and accompanying innovative experimentation with new budgetary processes is promoted by tax-exempt leasing.

Second, I believe that portfolios of real assets owned by tax-exempt entities will be better managed with tax-exempt leasing.

Third, I believe that privatization of the provision of so-called public infrastructure and services will be promoted by tax-exempt leasing, and that this will lower the real resource cost associated with providing these goods and services.

Fourth, I believe that pressure for direct grants from the Federal Government by State and local governments will be reduced as a result of tax-exempt leasing.

As an additional consequence of tax-exempt leasing, I believe that receipts to the U.S. Treasury will increase, not decrease.

Thank you.

The **Chairman**. Thank you very much. We are aware of the differences, and we will be glad to be working with you as we get into the bill.

[The prepared statement follows:]

Prepared Statement of Steve H. Hanke
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and

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Presented before the United States Senate Committee
on Finance, Washington, D.C. on July 19, 1983.

Mr. Chairman, ladies and gentlemen, my purpose is to comment on the Governmental Lease Financing Reform Act of 1983 (S. 1564). This proposed act would eliminate tax credits and accelerated depreciation for private property subject to tax-exempt leases. By eliminating so-called "tax benefits" for lessors, who lease to tax-exempt entities, this act would treat this class of lessors differently from other private sector investors; it would impose higher effective tax rates on private assets subject to leases, when the leases are between private lessors and tax-exempt entities. Thus, to obtain a given after-tax rate of return on assets subject to these lease deals, investors would have to increase required lease payments, and this would increase costs for tax-exempt entities, either by causing them to actually pay the higher lease payments or by causing them to switch to nonlease forms of public finance and public supply.

Faulty Analysis -- The Myths Associated with S. 1564

The prospect of increased leasing by tax-exempt entities has brought forth a flood of negative journalism, which has given widespread currency to a variety of myths. Since much of the advocacy for the Governmental Lease Financing Reform Act of 1983 is based on these myths, allow me to address some of them. (For additional analyses of tax-exempt leasing, see: Steve H. Hanke, "H.R. 3110--Leasing 'Reform' Threatens Cities," The Heritage Foudnation, Issue Bulletin No. 93, June 21, 1983.)

Myth 1 -- Tax-exempt leasing causes large reductions in Federal tax receipts.

It is asserted that tax-exempt leases create tax deductions and credits where they did not exist before, and that these so-called tax benefits will reduce Federal tax receipts. While the first part of this assertion is correct the second part is false. This false conclusion results from an incomplete and faulty analysis of the tax consequences of tax-exempt leasing.

In addition to creating a stream of annual tax benefits for lessors, tax-exempt leases also generate a stream of annual lease payments. After the annual tax deductions are subtracted from the annual lease payments, annual taxable income remains. And after appropriate tax rates are applied to annual taxable income an annual Federal tax liability is produced. These annual liabilities can be reduced if annual tax credits are available.

Once we include lease payments, as well as tax benefits, in our analysis--it should be clear that lessors, who engage in tax-exempt leases, face positive effective tax rates, and that the present value of cash flows from these lessors to the U.S. Treasury is positive. Lessors, who engage in tax-exempt leasing, face effective tax rates that are positive, and furthermore, the rates that they face are identical to those that investors face in cases where the same type of private assets are used for nontax-exempt purposes.

So, the U.S. Treasury does not lose receipts due to tax-exempt leasing; the U.S. Treasury actually gains receipts. To illustrate the tax consequences of tax-exempt leasing, we will use a sale-leasback deal--since these deals are alleged to cause large losses of tax receipts. To properly analyze the tax consequences of the Governmental Lease Financing Reform Act of 1983, we must evaluate the taxes with, and without the proposed act.

Let us begin with the situation as it would exist with the proposed act. In this situation, a sale-leaseback deal would not be attractive, and the publicly-owned asset would, therefore, remain an asset of the tax-exempt entity. As such, the asset and its service flows would not be subject to Federal taxes. Hence, with the proposed act, the U.S. Treasury would not collect any taxes from the publicly-owned asset or its service flows.

Now, let us examine the situation without the proposed act. In this situation, a sale-leaseback deal would be attractive, and the publicly-owned asset would be privatized. As a result, the private asset's income stream, adjusted for available tax deductions and credits, would create a positive Federal tax liability.

Therefore, with the proposed act, no Federal tax receipts are generated. And, without the proposed act, positive Federal tax receipts are generated. Hence, the U.S. Treasury is better off without the proposed act than with it.

Myth 2 -- Tax-exempt leasing leads to shaky financing schemes replete with public policy problems.

Since long-term leasing allows State and local governments to subvert the ordinary budget processes and to, therefore, avoid many of the ordinary limits on long-term borrowing (like voter approval and debt limits) -- it is asserted that tax-exempt leasing subverts efforts by governments to maintain budget discipline.

This line of argument implies that there is evidence to indicate that orthodox budgeting processes, and in particular those associated with the issuance of long-term municipal bonds, offer more budget discipline and are more rational than the processes by which publicly owned assets are privatized and leased back to State and local governments.

To my knowledge, however, there are no empirical studies available which would support this line of reasoning. Furthermore, it can be argued that the unorthodox budgeting and management processes associated with sale-leasebacks actually improve the way tax-exempt entities manage their assets. For example, in Baltimore, Maryland,the city's Trustees have business experience, and have injected an element of business savvy and commercial discipline into the management of the city's asset portfolio by using, among other devices, sale-leasebacks and lease-leasebacks.

We should also ask whether it is not presumptuous of the Congress to pass Federal laws that are designed to "instruct" State and local governments as to the most effective budgetary processes for the attainment of budgetary discipline. In fact, we could make a strong argument that federalism and State and local experimentation with alternative budgeting and management processes are in fact desirable, since these experiments -- such as privatization through leasing -- might generate information that would further demonstrate the advantages of providing so-called public infrastructure and services in alternative private ways.

Myth 3 -- Tax-exempt leasing often involves only "paper transactions," and, therefore, it is undesirable.

If this myth were true, it would imply that orthodox bond financing was also undesirable, since bond financings are also only "paper transactions" in which the State and local governments' tax bases are put up as collatoral.

In a lease deal -- a sale-leaseback -- that is a pure "paper transaction",the tax-exempt entity is simply using real assets that it has in its portfolio as "collateral" for an alternative type of financial instrument, a lease. This should not alarm us. After all, why should State and local governments be forced to hold a sterilized portfolio of real assets?

Myth 4 -- If the Federal government is going to subsidize tax-exempt entities, it should do so directly through grants and not indirectly through the tax system via leasing.

The problem here is that, on the one hand, direct grants require real Federal expenditures. Hence, direct subsidies occur. On the other hand, leases to tax-exempt entities do not involve direct or indirect subsidies through the tax system. Lessors, who lease to tax-exempt entities, are taxed in exactly the same manner as other private institutions,in equivalent situations who are not leasing or selling goods and services to tax-exempt entities. So where are the subsidies?

If, indeed, we argue that there are subsidies associated with these lease deals, then we must argue that there are subsidies also going to all private investors, regardless of the final consumers for their goods and services. If we do this and if we also accept the conclusion drawn from "Myth 4," then we must conclude that it is desirable to allow no tax deductions and credits and to subsidize all private business investment by targeted direct grants.

Desirable Consequences From Not Adopting S. 1564.

1. Federalism and accompanying experimentation with new budgetary processes will be promoted.

2. Portfolios of real assets owned by tax-exempt entities will be managed more efficiently.

3. Privatization of the provision of so-called public infrastructure and services will be promoted, and this will result in lower real resource costs for the provision of these items.

4. Pressure for grants from the Federal government by State and local governments will be reduced.

Additional Consequence From Not Adopting S. 1564.

1. Receipts to the U.S. Treasury will increase.

Mr. Chairman, I will now be pleased to answer any questions that you and your colleagues might have, and I might add that I will be willing to discuss any of the technical details associated with my testimony with your staff at a suitable time. Thank you.

STATEMENT OF DELMAR K. BANNER, PRESIDENT, FARM CREDIT COUNCIL, WASHINGTON, D.C.

The CHAIRMAN. Mr. Banner, of the Farm Credit Council, I understand you are included in the House bill. You shouldn't be; I think you pay taxes. Right?

Mr. BANNER. Yes, sir. That's correct.

The CHAIRMAN. We are glad to have you here, and your statement will be in the record.

Mr. BANNER. That's essentially the substance of my testimony, Mr. CHAIRMAN.

I am here on behalf of the 400 production credit associations across the country, and I am delighted to speak in their behalf. My purpose is to respond to the concerns that you have raised in your floor statement with regard to the possible adverse effect that the bill might have on taxable government entities. This is a loophole-closing bill and, with respect to PCA's, there is no loophole.

The production credit associations are engaged in the business of making short- and intermediate-term loans and offering financially related services to farmers and ranchers, about some $35 billion in 1982. These borrower-owned credit cooperatives operated under Federal charters issued by the Governor or the Farm Credit Administration, pursuant to the Farm Credit act of 1933, now superseded by the act of 1971.

By virtue of that act, the PCA's are designated "federal instrumentalities," notwithstanding that PCA's are engaged in wholly commercial pursuits and today are fully subject to tax at the Federal and State levels. In fact, in 1982, they paid some $38 million in taxes, and over $45 million in 1981. Approximately 90 percent of that amount is at the Federal level.

This legislation is specifically directed at curbing abuses involving leasing by tax-exempt entities. We are concerned that the legislation not inadvertently affect the ability of PCA's as taxpaying corporations to claim ACRS deductions and investment tax credits.

Unlike the House version, S. 1564, as introduced, properly defines tax-exempt use property such that property in the hands of PCA's would still qualify for ACR deductions and investment tax credits. I would urge that the committee guard against any change in the bill that would cause fully taxable Government instrumentalities to be treated as tax-exempt entities for purposes of this legislation.

Thank you.

The CHAIRMAN. Right.

Now, I think we have taken care of your concern in our bill. You don't have any problem with our bill, do you?

Mr. BANNER. No; we have no problem with it, as introduced, sir.

The CHAIRMAN. And, as I understand, you wanted to be here to make the record that I think the House, probably in a inadvertent drafting error, or whatever——

Mr. BANNER. We are optimistic that it can be corrected there.

[The prepared statement of Mr. Banner follows:]

STATEMENT OF DELMAR K. BANNER, PRESIDENT, FARM CREDIT COUNCIL ON BEHALF OF PRODUCTION CREDIT ASSOCIATIONS

SUMMARY STATEMENT

1. Production Credit Associations ("PCAs"), chartered by the Farm Credit Administration under the Farm Credit Act of 1933, as amended, are engaged in the business of making short and intermediate term loans and offering related financial services to farmers and ranchers. Thus, notwithstanding their Federal charter, PCAs are engaged in wholly-commercial pursuits.

2. PCAs are fully subject to Federal and state income taxation. Accordingly, the abuses involving leasing by tax-exempt entities to which this legislation is directed are not applicable to PCAs.

3. ACRS deductions and the investment tax credit were enacted to stimulate investment by taxpaying corporations. There is no justification for denying such incentives to PCAs merely because they are denominated "federal instrumentalities" under the Farm Credit Act.

4. The Production Credit Associations urge that the Committee reject any changes to S. 1564 which would result in privately owned and fully taxable governmental instrumentalities being treated as "tax-exempt" entities for purposes of the Governmental Lease Financing Reform Act of 1983.

My name is Delmar K. Banner and I am President of the Farm Credit Council, a federated trade association created to represent, at the national level, the interests of cooperative farm credit lending institutions, including the more than 400 Production Credit Associations. On behalf of the Production Credit Associations ("PCAs") in our association, I appreciate this opportunity to comment on S. 1564, the Governmental Lease Financing Reform Act of 1983. In particular, I wish to respond to concerns which Senator Dole raised in his statement of June 29, 1983, upon introduction of S. 1564, in regard to the possible adverse impact the bill may have on taxable government entities.

Production Credit Associations, chartered by the Farm Credit Administration under the Farm Credit Act of 1933, as amended, are engaged in the business of making short and intermediate term loans and offering related financial services to farmers and ranchers. Notwithstanding their Federal charters and statutory mandate to serve the agricultural sector, PCAs are engaged in wholly-commercial pursuits and today are fully subject to Federal and state income taxation. According to the combined statement of earnings of PCAs for the years ended December 31, 1982, and December 31, 1981, prepared by the Farm Credit Administration, PCAs accrued for Federal and other income taxes approximately $38,446,000 for 1982 and $45,940,000 for 1981. It is estimated that about 90 percent of this total represents Federal income tax liability.

PCAs are concerned, therefore, that legislation directed at curbing what many perceive as abuses associated with the use of leasing arrangements by certain tax-exempt Federal instrumentalities not inadvertently affect their ability as commercial, taxpaying corporations to claim accelerated cost recovery system ("ACRS") deductions and investment tax credits.

Under S. 1564 as introduced on June 29, 1983, the proposed limitations on ACRS deductions would apply to "tax-exempt use property," which is defined as any property used by a "tax-exempt entity." Section 2(a) of the legislation would amend section 168(f) of the Internal Revenue Code of 1954 so as to define "tax-exempt entity" as

> "(i) the United States, any State or political subdivision thereof, any possession of the United States, any foreign government, any international organization,
>
> . . . .
>
> (iii) any person who --
>
> (I) is not a United States person, or
>
> (II) is an agency or instrumentality of an entity described in clause (i),
>
> but only with respect to property 80 percent or more of the income derived from the use of which is not subject to tax under this chapter."

Under Section 2.10 of the Farm Credit Act of 1971, 12 U.S.C. §2091, PCAs are designated "federally chartered instrumentalities of the United States" and thus would be described in clause (iii), subclause (II), cited above. However, because PCAs are fully taxable on their earnings, they would appear to be excluded from the above definition of "tax-exempt entities" by virtue of the underscored concluding language. Similar language is contained in the proposed amendment to section 48(a)(5) of the Code. Thus, PCAs would continue to be eligible for regular ACRS deductions and investment tax credits under S. 1564 as presently drafted. For the reasons set forth below, we believe such a result is correct and therefore urge the Committee to take no action to deny the incentives of ACRS deductions and investment tax credits to PCAs merely because they are denominated as Federal instrumentalities.

The genesis of the proposed legislation has been the celebrated cases, such as the charter/leasing arrangements entered into by the Department of the Navy for certain ships, outlined in the June 29, 1983, floor statements of Senators Dole and Metzenbaum. Earlier this year, the Subcommittee on Oversight of the House Ways and Means Committee conducted public hearings on the above-noted Navy leasing deal and the other controversial leasing transactions. We have carefully reviewed the testimony offered at that hearing, the staff reports which have dealt with the issues raised by such leasing arrangements, and the statements of the Senate sponsors of S. 1564. Our review did not disclose a single instance where concern was expressed with respect to the propriety of tax benefits enjoyed by taxable governmental instrumentalities. Indeed, even a cursory examination of the issues discussed makes it clear that the abuses identified by the press, the House Subcommittee, and the Senate sponsors were necessarily associated with tax-exempt governmental units.

The report of the House Subcommittee on Oversight, after analyzing the Navy leasing arrangements, concludes that the long-term leasing of major assets by the Federal government "is more costly than purchase of the same assets." This is based upon the assumption that the government's cost "consists of rental payments and the revenue loss as a result of net tax benefits available to the lessor." The assumption may be a valid one in the case of the Navy and other nontaxable governmental units. It is not valid, however, with respect to PCAs because it fails to take into account the fact that PCAs pay Federal income tax on their earnings, thus offsetting any "Federal cost" associated with their use or ownership of property qualifying for the investment tax credit and ACRS deductions.

Indeed, it is difficult to even think in terms of "Federal cost" in the context of PCA expenditures for depreciable property. PCAs receive no appropriated funds. Funds to support PCA lending operations are borrowed from twelve regional Federal Intermediate Credit Banks ("FICBs"). The

FICBs in turn raise their funds through the issuance of Farm Credit System notes and debentures. These notes and debentures are neither obligations of nor guaranteed by the Federal government. Although the PCAs were initially capitalized by the United States, all government capital has been retired. Today, all the stock of PCAs is owned by their members/borrowers. PCAs are governed by boards of directors elected by such members/borrowers. Like the other lending institutions with which they compete, PCAs are subject to government regulation, and, like such other lenders, PCAs operate with an earnings objective. Because PCAs are cooperative farm credit lenders, their earnings inure to the benefit of their members/borrowers.

In Chairman Dole's June 29, 1983, introductory statement on S. 1564, he indicated that the legislation would provide a "comprehensive, fair system for treating leases by State and local governmental units, foreign tax-exempt entities, tax-exempt organizations, and the Federal Government." In explaining the abuses which S. 1564 was designed to cover, Senator Dole noted that "all of the lessees -- the users of the property -- are tax-exempt. Some are charitable organizations, some are foreign persons exempt from U.S. tax, some are State, local, and Federal governmental entities. Thus, the lessees are already paying no taxes -- they are the preferred entities of our tax system . . . . What leasing permits these nontaxpayers to do is to trade on their tax exemption. Such entities are unable to use tax credits and accelerated depreciation -- ACRS -- which are designed to reduce the cost of capital for taxpayers. A lease permits the nontaxable entities to sell such tax preferences. As a result, such tax-exempt entities are able to obtain a negative tax rate through leasing." Again, the concern about negative effective tax rates obviously has no application to PCAs, which are fully subject to Federal income taxes on the earnings derived from their lending and service activities.

In this regard, PCAs should be treated no worse than a tax-exempt charity or government instrumentality which uses property in connection with an unrelated trade or business subject to Federal income tax under section 511 of the Code. Such property of a tax-exempt charity or government instrumentality is, and under the proposed legislation would continue to be, eligible for the investment tax credit and full ACRS deductions. See Rev. Rul. 82-218, 1982-51 I.R.B. 5 (treating a state university engaged in an unrelated trade or business -- i.e., the operation of a commercial television station -- as a private entity rather than as a governmental unit or instrumentality for purposes of qualifying property used in such business for the investment tax credit). It follows a fortiori that PCAs, as fully taxable corporations, should qualify for such tax benefits.

ACRS deductions and the investment tax credit were enacted to stimulate investment by taxpaying corporations. We are aware of no justification for denying such incentives to PCAs merely because they are federally chartered and are denominated "federal instrumentalities" under the Farm Credit Act. On behalf of the Production Credit Associations, I urge, therefore, that the Committee continue to ensure, as does S. 1564, that privately owned and fully taxable governmental instrumentalities not be treated as "tax-exempt entities" for purposes of the Governmental Lease Financing Reform Act of 1983.

The CHAIRMAN. The entire statements of each of the witnesses will be made a part of the record.

Senator Long.

Senator LONG. I just wanted to get one thing straight for the record.

I raised a question with Mr. Lissenden, who was speaking on behalf of the Municipal Finance Officers Association, about a minimum tax applied to the interest on the State and municipal bonds. He said the minimum tax did not apply. That's correct.

I was trying to recall what I had in mind. What I had in mind was this. The social security bill has the effect of taxing the interest income on State and municipal bonds, and here's how it does it: You add the adjusted gross income of the taxpayer to one-half of the social security benefits. If that figure exceeds $25,000, then he pays an ordinary income tax on one-half of the amount that exceeds the $25,000, or one-half of his social security benefits, whichever is less.

For example, assume that a retired person has an adjusted gross income of $20,000 and social security benefits of $10,000, so that his adjusted income, when added to one-half of his social security benefits, equals $25,000. Then let's assume he has $5,000 of tax-exempt—or previously tax-exempt—income from State and municipal bonds. By reason of that $5,000 of income on the State and municipal bonds, he pays a tax on $5,000 of income at ordinary rates.

So the breakthrough has been made by the Congress to tax State and municipal bonds. If that remains the law, that will find its way up to the Supreme Court. In due course we will see whether the Court is going to uphold the right of the Congress and the Federal Government to tax interest on State and municipal bonds. It sets the stage for a direct confrontation on the issue. If the Court does permit such taxation, I'm sure that many of our so-called tax reformers would then want to contend that all State and municipal interest ought to be taxed—not just under the social security rules, but all of it. And of course there are many people who do not think that State and municipal bond interest should be treated any differently than other interest.

This committee has voted to put a tax on State and municipal bond interest. The committee sponsored an amendment which does have the effect, now, of taxing the interest income on State and municipal bonds held by elderly people who are social security beneficiaries.

Senator D'Amato and this Senator are sponsoring a measure that would repeal the tax on State and municipal bonds created by the social security bill. I am simply seeking to make the point that things happen in a rush, sometimes so fast that people don't know about it.

If I understood him correctly, Mr. Lissenden is apparently is not familiar with that point, and he made a speech for the Municipal Finance Officers Association. I honestly think that if the finance officers of our State and local governments had known about this proposal to tax interest on State and municipal bonds, they would have expressed themselves and the proposal would not have been enacted, because it had a very close vote on the Senate floor.

But that is the law today, and the States are going to have to defend their tax-exempt status before the Supreme Court, the way the thing stands today. I hope that we can persuade the Congress to change the law. But that's how it happened, and sometimes it happens so fast it would make your head swim. I have seen it happen in this committee that fast.

I would hope that in acting on these things we do take a good look.

I want to say that there have been a lot of changes in the bill that make it a much better bill, by virtue of careful consideration. I do hope that we will focus sufficiently, so that any unintended victims will be protected before we are through with this legislation.

I favor eliminating tax loopholes for those who were not intended to be benefited by them; but I do not favor eliminating tax incentives that we provide for a good reason and which still serve a very good purpose.

The CHAIRMAN. Thank you, Senator Long.

I think this particular panel—it probably wouldn't have been necessary for them to travel to Washington. But you are here, and you have indicated some of your concerns. I told Mr. Rafanello that we are looking into that problem. Mr. Booth and Mr. Kehoe, we are aware of your concerns; and where the private investor really bears the risk for the project and stands to reap the rewards, and operates the project, then we don't intend for S. 1564 to deny the tax credit or other benefits to such a project. I don't think you quarrel with that; is that correct?

Mr. BOOTH. I don't think we quarrel with that, what the intention of the bill is; but I think the effect of it will be to declare a moratorium on financing these projects for a period of at least 2 or 3 years, for those 50 projects now that are trying to be financed.

So I think apparently there is a difference of opinion on the effect of the bill. In reading it, we didn't think that your purpose was to affect these projects.

The CHAIRMAN. As you indicate in your statement, they bear a risk. If they don't, if it is purely tax motivated, then you've got a problem.

Mr. BOOTH. The problems in finance are getting bond opinions based on issues which may be up to the Treasury to decide at some later date. You simply can't get a bond opinion that will allow you to finance a project if there is any question at all about the tax liability.

The CHAIRMAN. Well, I think the House, as I understand, intends to move rather quickly on this legislation. And I would assume we would, too. So if there is a question, we are not going to try to drag it out.

And we are aware of the Heritage Foundation's concerns. We will be working with you on that.

Senator Boren, do you have a question?

Senator BOREN. Mr. Chairman, I just wondered—I wanted to ask Mr. Hanke. I am concerned about pending projects.

You mentioned in your testimony the increase in costs that would perhaps result if public facilities—let's take hospitals as an example. I know we have a couple of hospital projects right now, expansions that are being financed in essence through the leasing mechanism.

You seemed to indicate in your testimony that you could anticipate an increase in costs for facilities, so that ultimately this cost would be borne by those who would use these facilities. What magnitude of increased cost might result if these mechanisms were no longer available?

Mr. HANKE. Well, the major effect of this particular bill will be to force these private projects into public works or public projects, and the costs will roughly double. In fact, there is a large literature in economics that reports on these cost differentials between public versus private provision, and it has come up with what is refered to as the "bureaucratic rule of two." If you want to find out what the public cost will be, just multiply the private cost by two, and you've just about got it. And as a rough rule of thumb, I think that's a reasonable assumption.

Senator BOREN. Do you have any idea how many projects nationwide might be in the process of taking place? I know I have talked to people—Baptists and Presbyterian hospitals in our State, in Oklahoma City, and I know Tulsa as a municipality is in the process of developing an alternate energy source facility which would be privately built. They seem to think it would have a very significant impact on their costs if they are brought under this bill and not allowed to complete it.

Do you have any idea how many projects might be affected nationwide that are in process right now?

Mr. HANKE. I don't know, Senator, but I do know that the National League of Cities has accumulated an inventory of these, and you might check with them to get the precise breakdown.

Senator BOREN. Thank you, Mr. Chairman.

The CHAIRMAN. I want to thank the panel. We will be working with the members of the panel as we get into the markup of the legislation.

I would say as we conclude the hearing, the record will remain open. If there are other witnesses who would like to submit statements, or any of those either here or in the Russell Building who would like to rebut anything that may have been said by other witnesses, or any member of the committee, certainly the record is open for that purpose.

This is an area that I think should be addressed. I don't believe there is anyone who would suggest there aren't abuses in the area, and that's what we hope we are addressing. If in fact we go too far, then we will take a second look.

I appreciate the testimony, and thank you all for coming.

[Whereupon, at 11:42 a.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

STATEMENT BY SENATOR ALFONSE D'AMATO ON SALE/LEASEBACKS BY TAX-EXEMPT ENTITIES

Mr. Chairman, I appreciate the opportunity to offer comments on the Government Lease Financing Act of 1983, S. 1564. This legislation would limit the use of sale/leaseback transactions by municipalities and other tax-exempt organizations. S. 1564 is a refinement of legislation introduced in the House by Congressman J.J. Pickle of Texas, H.R. 3110.

The impetus behind both bills is an attempt to limit a perceived double subsidy enjoyed by local government and non-profit organizations in such transactions. The principal sponsors of S. 1564 and H.R. 3110 believe that entities which enjoy tax-exempt status should not also accrue the benefits of accelerated depreciation and investment tax credits. They argue that this supposed double subsidy enjoyed by government units and tax-exempt organizations in sale/leaseback financing represents an abuse of the tax code and, thus, a loss to the federal treasury.

Needless to say, I have serious difficulties with the intent of S. 1564 and H.R. 3110 and I take exception to the rationale behind the legislation. Moreover; I believe that the sponsors of the bills are guilty of analyzing sale/leasebacks by tax-exempt entities in a vacuum. Sale/leaseback activities by state and local governments expand the tax base and do not cost the Treasury revenues. The existing avenues of municipal finance have been consistenly narrowed over the past three years. Thus, to limit sale/leasebacks would be a further blow to local government. Individual taxpayers will pay for the added costs in the end.

The Economic Recovery Tax Act of 1981 mandated a three year, 25% personal income tax reduction plan. This strategy has done much to encourage investment by corporations and savings by individuals. In fact, the savings generated by the tax cuts cushioned the impact of the recession. However, lowering tax rates has encouraged individuals to shift their investments from tax-exempt securities to taxable activities. This has had the effect of reducing demand for municipal bonds. Consequently, the spread between taxable securities and tax-exempt securities has narrowed. I say this not as a criticism of the President's tax strategy. I believe the tax cuts have been beneficial to the economy. I only state the fact that municipal rates have increased, in part, as a result of reducing individual marginal tax rates.

The recession has also had a detrimental impact on the tax-exempt securities market. The tax base has been eroded, causing the credit quality of states and cities to deteriorate. This has reduced the supply of potential investors and has forced-up tax-exempt rates. Also, the federal government has endeavored to reduce grants to cities and states, which has further exacerbated their credit decline. Finally, bank profitability has fallen, reducing their need to purchase municipal bonds. Heretofore, commercial banks have been the single largest purchaser of municipal securities.

The picture I have painted is one where the primary avenue of funding available to state and local government -- general revenue bonds -- has been steadily eroded. This has had the effect of increasing both interest costs and taxes, as well as reducing essential services. However, municipal finance officers have reacted to this trend by becoming even more innovative. Sale/leasebacks of projects have shifted the financing burden more onto the private sector. This financing vehicle not only saved money through use of the more efficient private sector, but avoided the increasingly expensive municipal bond market.

The ultimate beneficiary of municipal sale/leaseback transactions are local taxpayers. Projects can be funded at favorable terms. But the great taxers in Washington are now attempting to destroy this activity through S. 1564 and H.R. 3110. These bills further reduce the funding available to cities and states. In the end, local taxpayers will be hurt. S. 1564 and H.R. 3110 attempt to reduce the federal deficit by shifting the burden onto local taxpayers.

Both bills, I believe, will fail as revenue raising measures. As I previously described, local officials have responded to a shrinking of the municipal market by an increasing use of privatization. Sale/leasebacks harness the private sector as a funding vehicle. This has resulted in holding down costs because of the inherent efficiency of the private sector. Obviously, cost savings are to the benefit of local taxpayers. Another outgrowth of privatization is an expansion of the tax base. In a sale/leaseback transaction conducted by a tax-exempt entity, taxable payments are made to private investors. If, instead of a sale/leaseback, the municipality sold tax-exempt bonds, the federal Treasury would accrue no benefits.

My point is that reducing federal income taxes has reduced the breadth of the municipal bond market. However, cities and states have responded to this crisis by shifting the financing of projects to the private sector. This has reduced costs and expanded both federal and local tax bases.

H.R. 3110 and S. 1564 would terminate the economic usefulness of most sale/leaseback transactions by government units and other tax-exempt organizations. S. 1564 would deny investment tax credits and ACRS depreciation for leased property used by tax-exempt entities. Exceptions exist for short-term leases, short-lived property, and certain real property. Criteria are established for determining when a service contract should be considered a lease for tax purposes. Rehabilitation tax credits are denied to tax-exempt entities that use industrial development bonds for rehabilitation purposes. If passed, S. 1564 would be effective May 23, 1983.

Congressman Pickle's bill, H.R. 3110, is similar to S. 1564 with certain exceptions. In H.R. 3110, short-term leases and short-lived property are treated the same as real property financed over long periods of time. H.R. 3110 denies rehabilitation tax credits if industrial development bonds are used by any entity to finance refurbishment. In nearly all other circumstances, including the effective date, the two bills are practically identical.

City and state governments would not be able to finance sorely needed major capital projects through sale/leasebacks if S. 1564 or H.R. 3110 were to be enacted. Neither bill attempts to deal with the selective abuses surrounding the use of sale/leasebacks. The sponsors' solution to these abuses is destroying the entire program. As I have stated, local taxpayers and the federal Treasury will suffer the most if either bill becomes law. I urge the proponents of the legislation to limit their efforts to only the abuses and not destroy a legitimate avenue of municipal finance.

United States Senate
WASHINGTON, D.C. 20510

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July 21, 1983

Honorable Russell Long
Ranking Minority Member
Senate Finance Committee
SD-221, Dirksen Senate Building
Washington, DC 20510

Dear Senator Long: Russell

I understand that Jack Schlenger has forwarded to the Finance Committee multiple copies of the enclosed statement he prepared on S. 1564. I would appreciate it if the statement would be made a part of the hearing record and made immediately available to committee members. It is regrettable that the committee was unable to receive Jack's testimony personally. He has extraordinary experience and expertise in the field of real estate development financing, and I believe the Finance Committee would have benefited from the opportunity to question him.

With best regards,

Sincerely,

Paul S. Sarbanes
United States Senator

PSS/jlk

Enclosure

WRITTEN STATEMENT OF
JACQUES T. SCHLENGER, PARTNER
VENABLE, BAETJER AND HOWARD,
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SENATE FINANCE COMMITTEE
JULY 19, 1983

I. Introduction.

A. Sale and leaseback transactions are being increasingly explored and used by municipalities, states and other tax-exempt organizations as a means of "realizing" the tax and other benefits inherent in the ownership of depreciable property. The "payments" for such benefits represent a significant potential source of revenues for municipalities, states and other tax-exempt organizations.

B. Sale and leaseback transactions provide an opportunity for "off balance sheet" financing, thereby reducing the drain on the municipality's borrowing capacity.

C. Sale and leaseback transactions, because they typically involve fewer regulatory approvals than do traditional borrowings, can often be used to cut through "red tape."

D. Where new construction is involved, sale and leaseback transactions can reduce costs by allowing for shorter construction periods, more efficient procurement, and more attention to costs and economics by the private developer-owner-lessor.

E. In certain instances, sale and leaseback transactions can be useful in adding properties to the tax rolls.

F. The new construction or rehabilitation financed by sale and leaseback transactions contributes to employment, economic activity and governmental control at the "grass roots" level, rather than through Washington-controlled programs.

II. Basic structure of a typical sale and leaseback transaction.

A. Because of tax peculiarities (unavailability of investment tax credits ("ITC") if leased to tax-exempt organization or governmental unit and no requirement that investors be "at risk"), most sale and leaseback transactions involve primarily real (as opposed to personal) property.

B. A municipality will typically lease the land underlying an existing improvement (or an improvement to be constructed) to an investor or limited partnership for a term of 40 to 50 years.

1. The ground lease will typically provide for the payment of a fair market rental with an inflation adjustment every 5 years or so.
2. At the expiration of the ground lease, any improvements will revert to the municipality.

C. The limited partnership will, following the ground lease, then acquire the existing improvements (or arrange for the construction of the new improvements) from the municipality.

1. The financing for the acquisition (or construction) will typically come from two sources: an issue of tax-exempt industrial development bonds ("IDB's") under Section 103* and contributions from limited partner/investors (amounts may be taken back as purchase-money financing by the municipality or a lease and leaseback of a facility may be structured, both possibly more attenuated and risky on the tax point of ownership by the investor). Note: A series of extremely intricate rules govern the availability of IDB's, and their availability in any given situation cannot be assumed. No exempt "small issue" IDB's may be issued after December 31, 1986. See Section 103(b)(6)(N).

2. The IDB's will typically have a term of 25 to 30 years. Because, as discussed below, the IDB's will be secured by a "triple net" ground and building lease with the municipality or state,

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*/ All Section references herein are to the Internal Revenue Code of 1954, as amended.

the interest rate on the IDB's should normally not be significantly greater than the municipality's or state's borrowing rate. When the cash payment or payments made by the purchaser-investor to the tax-exempt seller-user are taken into account, the effective interest rate is generally less than the governmental unit's normal borrowing rate.

3. The payments from the investors will typically be made over a 5 to 6 year period in approximately equal installments.

D. The land and improvements will then be leased back by the limited partnership to the municipality, state or tax-exempt organization.

1. The ground and building lease will typically have a term equal to the term of the IDB's (i.e., 25 to 30 years).

2. The rental under the ground and building lease will be equal to the sum of the following: (i) the rental under the ground lease; (ii) the debt service on the IDB's; and (iii) a profit factor equal to 3% to 5% of the investor payments (a current, cash return on cash invested). Note: All or a portion of the investor payments could be used to reduce the rental payments due from

the municipality, state or tax-exempt organization under the ground and building lease over the first 5 or 6 years (called "rent abatement"), as opposed to being used to make payments of purchase price, as discussed above.

3. The ground and building lease is a "triple net" lease pursuant to which the municipality, state or tax-exempt organization is responsible for all taxes, insurance, and repair and maintenance expenses.
4. Both the profit factor and the "gap" between the term of the ground lease and the term of the ground and building lease are considered necessary to make the purchaser-lessor the owner and give the transaction substance for federal income tax purposes. See U.S. v. Frank Lyon Co., 435 U.S. 561 (1978).
5. The interests of the municipality, state or other tax-exempt organization during the "gap" period are typically protected by the following:
   (i) The municipality, state or tax-exempt organization can be given an option to acquire the improvements at the expiration of the ground and building lease at their fair market value.

(ii) The municipality, state or tax-exempt organization can re-lease the improvements at fair current rent during the "gap" period.

(iii) The municipality or state may be able to condemn the improvements.

(iv) One apparent reason for the new wrinkle of a lease-leaseback is the apparent reluctance of the municipality, state or tax-exempt organization to part with legal ownership, economic realities notwithstanding.

(v) The substantial ground rental payable by the owner-lessor partnership during the "gap" period provides substantial "negotiating leverage."

(vi) The owner-lessor limited partnership will have an incentive to dispose of the improvements after the tax benefits are exhausted (i.e., after 10 to 15 years). Under the "Accelerated Cost Recovery System", ("ACRS") of Section 168, the cost of real property (other than land) may be recovered over a period of 15 years. ACRS does not apply to property owned and used by a municipality, state or tax-exempt organization before 1981.

E. The IDB's are secured by an assignment of the ground and building lease and by a mortgage of the improvements. Because of the assignment of the ground and building lease, the interest rate on the IDB's will tend to approximate the municipality's or state's borrowing rate.

III. A few "rules of thumb."

A. Because of the "at risk" rules, real (as opposed to personal) property is generally a more attractive candidate for a sale and leaseback. Section 465(c)(3)(D) provides an exception to the at risk rules for the "holding of real property."

B. Because "ACRS" is generally not available with respect to property first "placed in service" prior to 1981 which is sold and leased back (See Section 168(e)(4)), new construction or property first "placed in service" after 1980 will generally be a better candidate for a sale and leaseback transaction.

C. Investment tax credits generally are not available with respect to property leased to a municipality or state. See Section 48(a)(5). An important exception exists with respect to "rehabilitations." An ITC will generally be available for rehabilitation expenditures even if such structures are leased to a municipality or state. Because of the value of the ITC's to investors, projects involving rehabilitation are prime candidates for sale and leaseback transactions.

IV. Legal and tax issues.

A. Sale and leaseback transactions involve a number of very complex legal and tax issues which need to be carefully considered by counsel.

B. Among the more significant legal issues are the following:

1. Will the sale and leaseback constitute a "borrowing" under the municipality's or state's charter or constitution? If debt, there may be a requirement of voter approval or a debt limitation.

2. Is the sale and leaseback of the municipality's or state's property permitted under its charter or constitution?

3. Will the ground and building lease (the primary security for the IDB's) be enforceable in accordance with its terms?

C. The primary tax issue is whether the limited partnership will be deemed the "owner" of the property for federal income tax purposes. See _Frank Lyon Co._, _supra_.

V. S. 1564 - General Comments.

A. The Bill makes no distinction between governmental entities and other tax-exempt entities such as hospitals and universities. If a profit-making hospital or school can take advantage of the tax and economic benefits available in a sale-leaseback or leasing transaction, then why should not a tax-exempt hospital or university be able to obtain such benefits?

B. The Bill has a minimal impact on what the Bill's proponents apparently view as the most abusive transaction - the sale-leaseback of existing buildings (e.g., Bennington College campus, Columbus, Ohio electric power plant). The vast majority of these transactions are governed by the "anti-churning" rules and, consequently, ACRS treatment is unavailable in any event. Conversely and unfortunately, the Bill has its greatest impact on the development and construction of new projects (or substantial rehabilitation of older buildings) which would be eligible for ACRS. Thus, the bill will diminish, in these times which trouble us all, both new construction and renovation and rehabilitation of run-down buildings by sharply reducing the available cost recovery deductions. The impact on jobs in the construction industry as well as on additions to the property tax rolls would also be significant and so adversely affect or further damage labor, local government and charitable organizations.

C. The Bill's approach does not deal, or at least rationally and fairly, with the supposed evil. If the supposed sale of the tax benefits of ownership by a governmental or tax-exempt organization is somehow wrong or undesirable, then the culprit is the governmental or tax-exempt organization, and it should lose its exemption or suffer some tax penalty. What rational policy is served by denying, for identical facilities, the tax consequences of ownership to the owner-developer when it leases to a tax-exempt lessee rather than a profit-making one? Of course, behind this entire process is a badly-crafted and administered income tax law and system featuring excessive, politically motivated nominal rates and the never-ending quest for relief by turning clumsiness and chaos to advantage. This Bill is a harmful diversion from dealing with this root problem. Gresham's law, applied to tax devices, will, by piggishness and wild extension of such practices, lead inevitably to corruption and failure. Why not let the courts and the IRS pick up the pieces?

D. The Bill's sponsors allege that sale and leasebacks add to the user's occupancy costs. I do not believe that at the state and local level this statement is accurate; my experience is to the contrary. I cannot adduce experience on the vagaries of federal procurement and practice.

E. The Bill's sponsors apparently believe sale-leasebacks, or variants are a novel, dangerous threat. Under President Eisenhower, post offices were privately owned and leased to the Federal Government. It is difficult to see how any decline in Washington can be assigned to this cause.

F. Perhaps the most insidious aspect of the Bill is the effective date - May 23, 1983. Although there is a "grandfather clause" for contracts entered into by May 23, 1983, it is the nature of these sale-leaseback transactions that binding contracts are not entered into until closing. Many deals (a number of which we see around the United States) which are well under way in terms of planning, negotiation and the incurrence of substantial costs (but which have not formally "closed") will be subject to the Bill.

  1. In fact, this Bill's effective date is representative of a disturbing trend in Congress. Just the introduction of this bill with its May 23, 1983 effective date casts a cloud over the entire area. Governmental and tax-exempt entities and private developers, and their attorneys, are unsure whether to proceed with well-developed

plans which are short of closing. No doubt this is the effect intended by the proponents of the Bill. But such action is, in effect, legislation (is not an action by a lawmaker which inhibits or encourages behavior legislation?) by one Member of Congress (or a few Members) without the support of the rest of Congress and the signature of the President.

2. It is doubtful, from the facts, that a serious problem exists, that this Bill represents a desirable approach if a problem exists, that this technically-flawed Bill should or will be quickly enacted, that if enacted much harm would be done because of deal time lags if the effective date were made prospective, or that our legislative bodies should sacrifice or modify our concepts of fairness to nab a few supposed tax miscreants. In any event, principles of openness and fairness suggest that the Finance Committee quickly issue some statement that new legislation will not be retroactive so as to enable the closing of transactions already near completion. Prospective deals will remain chilled, however dubiously.

STATEMENT OF
GOVERNOR BILL SHEFFIELD
STATE OF ALASKA
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE ON S.1564
July 19, 1983

The State of Alaska opposes the enactment of S. 1564 in its present form. We are generally opposed to S. 1564 because it will have a substantial effect on Alaska as well as other state or local governments which rely on the private sector to finance and build public facilities for governmental use. A state or local government may wish or need to rely on the private sector to finance governmental facilities or projects which the government can then lease from the private sector. This type of financing has been used throughout the State of Alaska to provide essential facilities for many years. In short, the Bill would eliminate an important method by which state and local governments are able to provide essential facilities and will restrict them to finance public facilities either with cash or public bonds.

We are particularly opposed to the provision in the bill which denies accelerated depreciation in cases where real property which has been financed in whole or in part by tax-exempt obligations and is used by a tax-exempt entity. The Alaska Industrial Development Authority has financed numerous facilities constructed and owned by taxable entities but leased by the state, political subdivisions or its entities. These projects included approximately eleven facilities in locations throughout the State, including Anchorage, Akutan, Valdez, Juneau, Dillingham, and Illiamna. The amounts financed have ranged from $250,000 for an office building in Juneau and Anchorage, with total financing approximating $7.2 million. The space provided by these financings has ranged from 650 square feet to 49,140 square feet. Two proposed financings currently being considered by the Alaska Industrial Development Authority would provide loans in the $8-10 million range each for office buildings in Fairbanks and Juneau.

S. 1564's denial of accelerated recovery periods for property which was financed by tax-exempt bonds and is used by a tax-exempt entity is simply a further attempt to restrict the use of tax-exempt industrial development bonds (IDBs). Legislation was pending throughout 1981 and 1982 to limit tax-exempt industrial development bond financing. The matter was finally resolved by the passage of TEFRA which enacted far-reaching limitations on the use of tax-exempt industrial development bonds effective January 1, 1983. Figures presented to the House Ways and Means Committee by the Public Securities Association (PSA) demonstrate that the limitations imposed by TEFRA have restricted the use of small issue IDBs. According to PSA, the volume of small issues was fifty-three percent (53%) lower in the first quarter of 1983 than in the same period in 1982. The changes made in TEFRA have not only reduced the volume of small issue IDBs, but also have eliminated the alleged abuses in the program. Therefore, we see no reason for Congress to eliminate one of the few programs that provides flexibility to local and state governments to solve their economic development problems; takes no Federal bureaucracy to administer; and adds a new source of tax revenues flowing to the Federal Treasury from the permanent jobs created through IDBs. (In fact, the surveys done by a number of states show that the Federal tax revenues generated by new IDB jobs more than offset the Federal revenue foregone due to the tax-exempt status of IDBs.)

We also would like to take this oportunity to go on record in opposition to H.R. 1635 and other proposals to impose new IDB restrictions (e.g., volume caps or a local contribution requirement). In light of the drastic changes made to the IDB program last year, it makes no sense to take any further action to restrict IDB use before the effects of these changes are studied. We are opposed to any action which would impose further limitations on IDBs.

In summary, we feel that the actions to restrict state and local governments' ability to rely on the private sector to finance or build governmental projects or facilities as well as actions to impose new and more drastic restrictions on IDBs are both ill-advised.

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Statement of
the American Federation of State, County and Municipal Employees

before the
Committee on Finance

On
S. 1564, the
Governmental Lease Financing
Reform Act of 1983

July, 1983

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This statement is presented on behalf of the American Federation of State, County and Municipal Employees (AFSCME), a union representing over one million public sector workers at all levels of government throughout the nation. We would like to take this opportunity to express our support of S. 1564, the Governmental Lease Financing Reform Act of 1983, introduced by Senators Dole, Metzenbaum, Durenberger and Grassley, which would curb the use of sale-leaseback transactions by governments and tax-exempt organizations.

AFSCME strongly endorses congressional efforts to restrict the public sector use of leasing transactions. Public sector leasing transactions, like safe harbor leasing transactions, are nothing more than another raid on the Federal Treasury. These transactions allow governments and other tax-exempt entities to share in the substantial tax benefits which recently have been made available to the private sector for new investments. The purpose of such transactions is to reduce the upfront cost of public investments by exporting a portion of the cost to federal, and even state and local, taxpayers.

Although leasing transactions are still not widely used in the public sector, their increased use is being recorded almost daily in newspapers, magazines and municipal finance publications. Just recently, the House Ways and Means Subcommittee on Oversight examined the growing use of leasing arrangements by the Federal Government and found that leasing was more costly than purchasing the asset directly.

It is also beginning to seem commonplace when a city announces its interest in entering into leasing arrangements for publicly owned sports arenas, sewage treatment plants and even city hall. Such transactions must be stopped now before all of the schools, city halls and other public facilities in this nation are sold to private investors.

State and Local Government Fiscal Crisis

Before discussing in detail our reasons for supporting S. 1564, it should be frankly acknowledged that leasing transactions are only a symptom of the current fiscal crisis facing state and local governments. We think it is only understandable that state and local governments will use all financing methods at their disposal, including leasing transactions, to try to generate additional funds to meet their enormous public investment needs.

We urge this Committee to address the underlying reasons why state and local governments are resorting to leasing arrangements as well as other unconventional financing methods. The reasons are clear and include:

- the enormous need for public investments to rebuild roads, sewers, bridges, mass transit, and other physical facilities.

- the high interest rates for municipal bonds.
- the grim fiscal reality facing state and local governments.

Throughout the nation, there is a growing realization of the enormous need to invest in maintaining and improving our nation's public infrastructure. The Congressional Budget Office recently reported that an additional $4 billion a year in federal spending is required through 1990 in order for the Federal Government to meet its broad responsibilities in improving our nation's physical infrastructure. Despite all this attention, sources for financing much needed new public investments - at the federal and local levels - have been inadequate.

Traditionally, state and local governments finance new investments through the tax-exempt bond market. This avenue of finance has become excessively expensive. Interest rates on municipal bonds has risen dramatically in recent years jumping from an average rate of 8.6% in 1980 to 11.7% in 1982. In addition, the advantage that tax-exempt issues normally enjoy over taxable issues has been greatly eroded. In 1980, the difference in interest rates between tax-exempt and taxable issues was over 4 percentage points, while in 1982 the difference was only 2 percentage points.

The combination of the reduction in marginal tax rates, the creation of alternative tax shelters, the enactment of generous tax subsidies to business and the proliferation of industrial development bonds have brought the municipal bond market to its knees. Clearly, the huge tax subsidy that the Federal Government is paying for tax-exempt issues is not being passed on as savings to state and local governments.

State and local governments cannot afford to pay these rates. The excessive interest costs of tax-exempt financing are a real burden to state and local governments who are in the midst of a fiscal crisis unlike any since the Great Depression. Lagging tax revenues combined with steep cuts in federal assistance have undermined the fiscal health of state and local governments throughout the nation.

Unfortunately, the arrival of the long-awaited economic recovery will prove insufficient in the near-term to heal the fiscal ills of state and local governments. In May of this year a National Governor's Association - National Association of State Budget Officers survey reported that for Fiscal Year 1983 state budget balances are expected to total only $346 million, or two tenths of 1 percent of current expenditures, and that if Texas were excluded the 49 state total would show a deficit. The survey indicates that the situation for FY 1984 will remain grim and seven states now anticipate a deficit for FY 1984.

Not only are state and local governments not able to afford to finance many needed public investments, but they are deferring required maintenance which is only adding to our nation's public infrastructure crisis.

Direct Federal Assistance Needed Immediately

AFSCME urges this Committee not to turn its back on the real fiscal problems facing state and local governments. We recommend that Congress take the following steps:

- provide additional revenue sharing and targeted counter-cyclical relief.
- create a grant program to meet the maintenance and construction needs of our deteriorating infrastructure, such as contained in H.R. 2554, the Emergency Public Works Employment Act of 1983, which was recently reported out of the House Public Works Committee.
- strengthen the municipal bond market by restricting the use of IDBs and by enacting a taxable bond option with direct federal subsidies to state and local governments.

Support for S. 1564

AFSCME supports S. 1564 because a careful examination of public sector leasing transactions reveals they are both an inefficient and fiscally irresponsible vehicle for providing needed federal support for public investments. While supporters of leasing transactions argue they are simply another way for the Federal Government to fund needed public investments, they fail to point out that such transactions are not a cost-effective subsidy. The major portion of the federal subsidy from leasing transactions goes to the private firm entering into the transaction as well as to the financial establishment negotiating the deal. Leasing transactions squander extremely scarce resources for public investments by utilizing unnecessary middle-men. We believe direct grants to state and local governments would be far more effective.

Permitting leasing transactions to fund public investments is also fiscally irresponsible. At a time of soaring federal deficits, leasing transactions represent an uncontrollable drain on the Federal Treasury. Since the federal subsidy provided by leasing transactions is passed indirectly through the tax system the Federal Government cannot limit the number of such transactions or the consequent cost to the Federal Government. In addition, public sector leasing transactions constitute an abuse of federal tax incentives which are designed for use by tax-liable entities, not tax-exempt entities. These arrangements erode the federal corporate tax base by increasing the use of business deductions and credits, and they shift a disproportionate burden of federal taxation to individual taxpayers.

Widespread use of leasing transactions threatens to undermine public accountability in investment decisions. We are concerned that the Congress may be losing its capacity to determine where scarce federal resources should be allocated. There are no standards in current law to insure that such transactions further important public policies.

S. 1564, the Governmental Lease Financing Reform Act of 1983, is an effective way to curb the use of leasing arrangements. The stated purpose of the bill is to limit the incentives for the public sector to enter into leasing arrangements by reducing the tax benefits flowing from such transactions. S. 1564 seeks only to eliminate those leasing transactions which are undertaken solely for the purpose of obtaining a federal tax benefit. It preserves the ability of state and local governments to enter into leasing arrangements that present real economic advantages.

Opponents of S. 1564 will point out that the Federal Government has unfairly favored private investments over public investments through generous tax benefits for the private sector. Permitting the public sector to share in these benefits, it will be argued, serves to correct this problem. We do not agree that encouraging the use of leasing transactions by state and local governments is the way to correct this unfair treatment.

The problem, in our view, is that the current Administration has succeeded in enacting tax subsidies for indiscriminate new private investments that are far too generous. Under the current tax system, many new investments are actually more profitable after taxes than before taxes are calculated. To ensure fair treatment of public and private investments, AFSCME urges Congress to roll back the imprudent tax subsidies enacted in the Economic Recovery Tax Act to provide neutral incentives for new investment while not undermining effective taxation.

We would like to thank the Committee for this opportunity to express our support of S. 1564. We would be pleased to provide the Committee with any additional information on this matter which you may require.

ahca
American Health Care Association 1200 15th Street, Washington, DC 20005 (202) 833-2050

August 5, 1983

The Honorable Robert Dole
SH 141
Washington, DC 20510

Dear Senator Dole:

On behalf of the 1,500 nonproprietary long term care facilities within the 8,000 member American Health Care Association, I write to express our views on S. 1564, the Governmental Lease Financing Reform Act of 1983. While this proposal is a substantial improvement when compared with the legislation under consideration in the House of Representatives (H.R. 3110), we still have reservations about S. 1564 as presently proposed.

The Senate version would reduce the tax benefits that would otherwise be available for property used by tax-exempt entities. While there may be justification for restricting certain leasing arrangements, the scope of the proposed legislation is too broad and could curtail many desireable activities. The adverse impact on nonproprietary long term health care facilities would be especially severe. We believe that such a consequence is not only unwarranted but would be inconsistent with Congressional objective of providing appropriate services to the growing number of elderly and chronically ill who will need long term health care.

One of the strongest trends in the nonproprietary segment of the long term care industry has been the professionalization of facility management. Prodded by public concern for the costs of health care as well as marketplace demands for cost consciousness, greater emphasis has been placed on prudent financial decisions by the health care community. Leasing and service contracts have thus become one of several important options available to the nursing home as a means of augmenting staff capacity and generating management efficiencies. The utilization of such arrangements has become a pattern in both the tax-paying and tax-exempt facilities within our membership.

In negotiating these leasing and service contracts, every effort is made by the provider to limit financial and technological risks. Obsolescence and rapidly increasing maintenance costs indicate that the actual economic decline in value of equipment used in health services is more accelerated than straight-line depreciation. Because of this, the administrator often shifts some of the financial exposure to the lessor. Such a prudent decision would be challenged if the depreciation provisions under S. 1564 are too stringent to encourage leasing by facilities under nonproprietary sponsorship.

The argument advanced in support of H.R. 3110 suggests that a tax-exempt entity circumvents the benefits of its exemption by passing its losses on to its supplier. While to an extent this is true, there is virtually no evidence

A non-profit organization of proprietary and non-proprietary long term health care facilities dedicated to improving health care of the convalescent and chronically ill of all ages. An equal opportunity employer.

to indicate the ultimate effect of this offset. In the nursing home industry, where nearly 60 percent of revenues is in the form of public program reimbursement, it would appear that the ultimate benefactor of such fiscally sound management is the government as payor. Leasing often offers the provider an alternative to costly front-end purchasing and/or long term financing. Cash flow and credit problems effect the cost and availability of capital and force providers to rely on lease transactions. In our view, S. 1564 could be improved by permitting certain leasing practices where the cost savings are passed-through to public reimbursement programs.

We are pleased that the Committee on Finance has sought to address the limitation, in the House proposal on this issue. We urge that in marking up S. 1564, further attention be directed at the specific needs of the health care provider.

Sincerely,

William Hermelin

William Hermelin
Administrator
Government Affairs Department

WH/LL:ac

831296.03

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STATEMENT OF THE AMERICAN HOSPITAL ASSOCIATION TO THE SENATE FINANCE COMMITTEE ON S.1564 THE GOVERNMENTAL LEASE FINANCING REFORM ACT OF 1983

July 28, 1983

The American Hospital Association, which represents 6,300 institutional members and 35,000 personal members is pleased to have this opportunity to comment on S.1564, the Governmental Lease Financing Reform Act of 1983.

While we recognize that this legislation is intended to eliminate certain abuses which have taken place in sale lease-back arrangements involving governmental and other entities, we believe that the special circumstances of nonprofit (tax-exempt) hospitals have not been adequately taken into consideration.

Generally, we find that nonprofit hospitals are not extensively involved in sale lease-back arrangements that this legislation seeks to restrict. However, it is very important to note that nonprofit hospitals, in particular, have special community obligations to provide services that are not considered to be cost effective or cost efficient and are often rendered without any charge to persons unable to pay. Moreover, these same institutions also tend to serve very significant proportions of Medicare and Medicaid beneficiaries. Clearly, these types of hospitals need every possible type of assistance to survive.

Federal resources and commitment, whether through direct grants, appropriations, reimbursement for services, or through certain tax policies, are all important factors in the financing of health care. Therefore, allowing nonprofit hospitals to take advantage of certain tax policies designed to benefit only taxable entities should not automatically be considered suspect or an abuse.

We also are very concerned about provisions contained in Section 2 of this measure which would prevent equipment owned by leasing companies and other taxable entities which are leased to nonprofit hospitals, to qualify for accelerated depreciation. We have similar concerns in regard to provisions affecting service contracts which prohibit service companies from receiving the investment tax credit for property used in fulfilling service contracts to tax-exempt entities.

All hospitals lease a great deal of sophisticated equipment that becomes obsolete very quickly due to changing technologies. In addition, many hospitals enter into service contracts for the purpose of providing services in a more effective and efficient manner at lower costs. It is our understanding that if S.1564 is enacted, lessors and service companies would incur large cost increases that would be passed on, particularly to nonprofit hospitals in their leasing costs and service contracts.

While we recognize that the bill does address this concern to a certain extent by providing an exception for short-lived property from the restriction on the use of accelerated depreciation, we are concerned that a great deal of hospital equipment will not meet the criteria used to determine such exceptions.

At a time when the rate of increase in health care costs is of significant concern we find these provisions counterproductive and urge you to consider further modifications in the bill that would address this important area.

In summary, we believe that legislation to refine federal tax policy should not inadvertantly disadvantage those hospitals which are carrying most of the burden for caring for the elderly and poor.

STATEMENT OF LAWRENCE L. REGER, DIRECTOR OF THE AMERICAN ASSOCIATION OF MUSEUMS BEFORE THE SENATE FINANCE COMMITTEE ON S. 1564

Mr. Chairman and members of the Committee:

Thank you for the opportunity to present testimony on behalf of the American Association of Museums on the proposed bill restricting leaseback arrangements between the profit and nonprofit sectors. The American Association of Museums represents over 4,500 art, history and natural history museums, as well as zoos, botanical gardens, aquariums, planetariums and science centers across the country. Virtually all of these facilities are either public charities or government-owned, and so are affected by the proposed bill.

Museums are the repositories of irreplaceable collections of objects and materials that embody man's history, culture and artistic achievements and provide the history of the natural world. The primary responsibility of museums--one that supersedes the development of exhibitions and public programs--is the physical preservation of these collections in perpetuity. This is a costly undertaking; protection of these cultural artifacts involves proper climate control, lighting, security, storage and work space. The unique requirements of collections make the museum building itself, then, an integral part of the preservation of collections.

Many of the nation's major museums are housed in aging facilities; most of these buildings have significant historical value. In order to provide adequate shelter to the objects in their charge and to maintain the integrity of their buildings, museums are finding that they require substantial funds for capital improvements. At the same time, federal allocations for cultural activities have declined, and there has been a concurrent shrinkage in state and local funds available to museums. The government allocations that are available are predominantly for the development of exhibitions and special projects. The Reagan administration has encouraged the cultural community to seek additional support and financial involvement from the private sector. This is what a number of museums have sought to do through sale and leaseback arrangements with the private sector.

Under the 1981 Economic Recovery Tax Act, the Accelerated Cost Recovery System (ACRS) allows investors to realize greater benefits than before in leaseback arrangements with the nonprofit and public sectors. The ACRS was enacted to encourage investment by the private sector and speed economic recovery. Whether it properly allows investors to claim deductions for depreciation in excess of the real depreciation of the property is unclear. Using the tax code to stimulate activity of a certain kind--regardless of whether the taxpayer "deserves" a particular deduction--is a common legislative strategy, the merits of which depend upon both economic and public policy considerations. In this context, I believe that investment in the preservation of culture and the resources of the nation's intellectual and artistic life is as important as investment in other areas of the economy.

Museums do not wish to trade on their tax-exempt status; they look for ways of attracting both public and private involvement in the task of collecting, sheltering, organizing and exhibiting artifacts. If investors are abusing the tax break available through leaseback arrangements, then restrictions against abuse need to be formulated and incorporated into the tax code. With proper safeguards, the general concept of leaseback is a sound one, at least as far as museums are concerned. It provides much needed capital for building improvements and involves private businesses and corporations in the activities of museums.

There are any number of studies that reveal the substantial contributions that museums and other cultural facilities make to the economic life of their communities in comparison to the cost of these facilities to local, state and federal governments. For example, the Toledo Museum of Art hosted an exhibition of works of El Greco in 1982. A study of the economic impact of the exhibit conducted by the University of Toledo revealed that the show brought from $12.6 to $18 million to the Toledo metropolitan area. Museums and other cultural facilities are often the centerpieces of urban renewal activities and contribute to increases in property values in the areas in which they are located. We believe that the health of a community's cultural life and the community's economic health are directly related. To the extent that the leasebacks and the ACRS are intended to stimulate the economy, they are effectively used in the case of museums.

The fact that the public good is served by the preservation of art and artifacts of history and science in public institutions, and that it is in the public interest for these institutions be fiscally sound, has been recognized by Congress and every administration in recent memory. The strongest reiteration of this belief was made by the report of President Reagan's Task Force on the Arts and Humanities, which saw as a top priority the encouragement through the tax code of private sector investment in the nation's cultural life.

I particularly urge that the rehabilitation tax credit which the bill would eliminate remain intact. Without this credit, many of the important historic preservation projects that have taken place in recent years, and many exciting projects that are currently underway, would not have been undertaken. The loss of the incentive for the rehabilitation of historic buildings and sites would directly result in the tragic destruction of increasingly large segments of the nation's patrimony.

If limitations on the leaseback arrangements now available are required, the AAM hopes that the "grandfather clause" be made more generous. The current provision that the bill apply to property placed in service after May 23, 1983 or those subject to binding contracts by that date should be revised to allow those institutions now under negotiation but not covered by a contract to complete their negotiations without penalty. Thus, we recommend that the bill, if passed, take effect six months to one year after becoming law.

The serious flaws in the current leaseback provisions should not obscure the potential such incentives provide for private sector investment in the cultural life of the country. Given the reductions in direct allocations available to museums and the halting of federal funds for bricks and mortar through Urban Development Action Grants and the Economic Development Agency, the elimination of a private sector incentive such as that provided through the allowance of leasebacks would directly result in a deterioration of the health of the nation's museums.

The AAM urges the committee to consider alternative ways of structuring the leasebacks provisions that will benefit museums and other cultural institutions and in turn pass the benefits on to the public and future generations. The American Association of Museums would be happy to work with the committee to this end.

Thank you.

Statement of
The Associated General Contractors of America
Submitted to the
Committee on Finance
U.S. Senate
July 19, 1983
on S. 1564
its impact of eliminating
lease-back arrangements which offer
the use of various tax incentives by
tax exempt entities on
Rebuilding America's Infrastructure

AGC is:

- More than 32,000 firms including 8,500 of America's leading general contracting firms responsible for the employment of 3,400,000-plus employees;
- 112 chapters nationwide;
- More than 80% of America's contract construction of commercial buildings, highways, industrial and municipal-utility facilities;
- Over $100 billion of construction annually.

The Associated General Contractors of America and its 112 chapters nationwide is comprised of approximately 32,000 firms including 8,500 of the nation's leading general contracting companies that perform more than $100 billion of construction annually. AGC member firms normally employ some 3,400,000-plus workers, a significant portion of our national labor pool.

S. 1564 would reduce the tax incentives which make private financing of public works facilities attractive by requiring straight-line depreciation over extended recovery periods for property used by tax-exempt entities. The bill would also revise present law denial of investment credits for this property. Although S. 1564 is intended to limit the use of these tax incentives in connection with the sale lease-back of existing facilities, AGC is concerned that these limits may be extended to cover new construction activity. If enacted with such an interpretation, this legislation could severely impact the effort to rebuild the country's aging infrastructure facilities.

Since June of 1981, the Associated General Contractors of America has been alerting the public to the steadily deteriorating infrastructure in the United States. AGC has surveyed existing literature and studies on infrastructure needs and contacted over 100 organizations, states and cities in an effort to develop a documented estimate of necessary investment to meet presently identified infrastructure needs. The AGC research reveals a minimum necessary capital investment of approximately $3.03 trillion. While the time frame for addressing such needs varies in the individual infrastructure categories, a weighted average indicates that most investment is projected to be necessary within the next 19 years.

Public works investments at all levels of government generally account for approximately 24 percent of all new construction put in place, or approximately $56 billion based on the 1982 value of construction put in place. Continuation of such inadequate public works investment levels would produce over the next 19 years (in 1982 dollars), a total investment of $1.06 trillion compared to the minimum necessary investment level of $3.03 trillion -- a total shortfall of approximately $1.97 trillion and an annual shortfall of $104 billion in 1982 dollars.

The AGC study reveals the diversity and complexity of funding needs. It also reveals that no single answer, no single investment strategy, no single funding mechanism will suffice. Each level of funding authority and responsibility has a role to play in devising a program to increase public capital investment.

One funding mechanism which will play an important role in the rebuilding effort is the concept which has come to be called "privatization." Under such an arrangement private companies, either individually or as a group, undertake the financing, construction and operation of a facility which has traditionally been the responsibility of the local governing body. Wastewater treatment facilities, in particular, are likely candidates for this type of funding arrangement.

In this era of reduced federal budgets and community moves to cut local taxation, municipalities and counties are finding it increasingly difficult to meet public works requirements. Many local governments are reaching their debt ceilings and therefore will not be in a position to borrow money in the bond market to finance these projects.

In much of the literature dealing with our existing infrastructure crisis, it is apparent that much of the problem can be traced to deferred maintenance. This deferral has resulted from the lack of available funds. Traditional funding of public works projects are often highly politicized and do not always result in the best long-term decisions. Privatization can help remove the issue from the political arena to the business arena without, however, removing it from public scrutiny.

Because of the significance of privatization to the infrastructure rebuilding effort, AGC cautions strongly against passage of S. 1564 without certain explicit exemptions. The intent of the legislation is to eliminate lease-back arrangements which offer the use of various tax incentives by tax exempt entities. When enacted these tax incentives were intended to motivate reindustrialization and new capital investment. It appears that the rationale for S. 1564's elimination of these arrangements is they are nothing more than paper work shuffles and do not provide for reindustrialization and new capital investment. In the case of new public facility construction and operation, however, this is not true, particularly in the case of wastewater treatment facilities. Construction of a public works facility is a significant type of new capital investment which spurs additional industrial development.

AGC urges that in acting on S. 1564 consideration be given to the need for the privatization concept as an alternative financing mechanism for rebuilding the infrastructure. AGC urges that S. 1564 be amended to allow for the use of these various tax incentives for the construction of new public works facilities.

WRITTEN TESTIMONY OF
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COMMITTEE ON FINANCE

U.S. SENATE

JULY 19, 1983

I. INTRODUCTION

Robert E. Agus and William A. Davis, Jr. are attorneys and principals in the firm of Associates In Community Development, Inc., which is based in Washington, D.C. The firm provides financial and real estate planning services by creatively structuring projects so as to be attractive to prospective private sector limited partners. ACD also assists its clients, including universities, colleges, and independent schools, to expeditiously raise funds needed to erect new facilities, rehabilitate older facilities, and lower considerably the cost of obtaining expensive equipment through participation in partnerships with private investors.

II. SUMMARY AND CONCLUSIONS

The proposed pieces of legislation, S.1564 and H.R. 3110, which pertain to leasing by governmental and tax-exempt entities, demonstrate the need for a comprehensive review of a number of related issues:

1) the general tax treatment of tax-exempt entities;

2) the actual impacts on the economy and the Treasury of the various tax incentives enacted by Congress, such as "ACRS", and the various investment tax credits, when tax-exempt entities are involved;

3) the relative costs to the Treasury of use by entities in the non-profit sector of tax-exempt bond financing versus true partnerships and sale-leasebacks; and

4) the contribution of the non-profit sector entities to the economic, social, and political vitality of the nation.

S.1564 and H.R. 3110 do not provide a proper focus to address these key issues. Congress should seize the opportunity to lead a major review of this area and to recommend a coherent policy. It should revise S.1564 or H.R. 3110, if legislation is felt necessary, in light of the policy arguments advanced below and with reference to the justification for a limited response (see Section II).

This paper advances the following public policy considerations in opposition to the passage of either S.1564 or H.R. 3110, as introduced.

1. The primary purpose of the various tax incentive measures enacted by Congress, such as those which permit acceleration of depreciation and investment tax credits for qualified rehabilitation expenditures or purchase of new equipment is to encourage growth of the nation's economy. This growth is measured by increased employment, higher business activity, and increased taxable income to individuals and for-profit entities. No evidence has been advanced that partnerships between tax-exempt entities and for-profit entities which utilize these tax incentives measures in any way defeats this Congressional intent. Rather, such partnerships enhance capital formation and economic growth beyond what might be expected from limitation of use of these tax incentive measures to the for-profit sector alone.

2. Partnerships between entities in the tax-exempt and for-profit sectors are consistent with Administration and Congressional goals of promoting private sector initiatives and limiting the need for reliance on the government sector to solve local social, welfare and economic problems. Tax advantaged investments by for-profit entities which have the added benefit of strengthening the private non-profit and charitable sector are arguably more beneficial to the nation than tax shelter investments which promote speculative oil and gas drilling, development of race horse farms, etc. Certainly, some further study is warranted to weigh all the costs and benefits to the nation of permitting such partnerships before such activity is arbitrarily precluded.

3. Passage of either S.1564 or H.R. 3110, as introduced, would enact a penalty on tax-exempt entities by making it more expensive for those entities to lease property than for entities in the for-profit sector. Public considerations would dictate that non-profit entities should be treated more favorably than for-profit entities since they are promoting charitable and public-related interests.

4. The Internal Revenue Service has adequate power through existing legislation and numerous IRS provisions and regulations to eliminate and prevent sham transactions which would lead to a drain upon the federal treasury. No evidence has been advanced that sale-leaseback transactions involving non-profit entities are more likely to cause a drain on the federal treasury than are those involving only for-profit entities. Furthermore, the language of S.1564 and H.R. 3110 is drawn in such a loose and broad-guaged way that an overly complex tax environment will become even more confusing resulting in the need for increased IRS rule-making, litigation, and judicial construction.

III. JUSTIFICATION FOR A LIMITED LEGISLATIVE RESPONSE

Though we believe that S.1564 and H.R. 3110, as originally introduced, are seriously defective in both their intent and some of their specific provisions, they respond to two strongly felt perceptions on the part of many members of Congress and the public. One is the sense that a number of sham transactions involving tax-exempt entities are being put together; the other is that, if unchecked, sale-leaseback transactions will produce an enormous revenue loss for the Treasury.

A careful response to those concerns will require a comprehensive analysis of both claims as well as a study of the other issues we have identified above. However, such analyses and studies take time, and if the concerns are based on accurate assessments, then the call for action, admittedly imperfect, cannot be ignored.

Therefore, we believe it appropriate for the proposed legislation to be amended in order to accomplish the following:

A. Inhibit Transfers of Property that Do Not Promote Economic Growth

The legislation should provide that property, used by tax-exempt entities, which is the subject of a sale-leaseback type transaction will qualify for accelerated depreciation (ACRS) and investment tax credits (I.T.C.) to the owner of such property if the transactions are likely to lead to increased economic activity, private investments, and employment. Transactions involving capital expenditures by private investors which result in new construction, substantial rehabilitation, adaptive reuse, or the utilization of new equipment should be presumed to be in the protected category.

However, such property which is the subject of a transaction where there is simply a shifting of ownership but no creation or enhancement of a capital asset should not be entitled to ACRS or ITC tax treatment.

This single amendment would protect the economic growth activities of tax-exempt entities and enhance the national effort to revive and strengthen the economy. On the other hand, it would inhibit the mere paper transfer of billions of dollars of property from tax-exempt entities to private ownership - a transfer that would not necessarily lead to economic growth and might produce a major loss in federal tax revenues.

B. Limit the Size of Transactions That Are Protected

Property used by tax-exempt entities which is the subject of sale-leaseback type transactions should qualify for treatment under ACRS and the I.T.C. if the size of the transaction does not exceed $25,000,000 in the case of governmental tax-exempt entities; in the case of private non-governmental public tax-exempt entities, there should be no limitation.

This provision, which should be seen as an emergency stop-gap legislative response, will serve as a further protection against enormous tax losses. Differentiation between the type of tax-exempt entities is based on the fact that governmental entities possess power to raise funds through taxation and budgetary allocations.

C. Permit the Availability of the I.T.C. on Personal Property Used by Tax-Exempt Entities

Personal property leased to tax-exempt entities by a for-profit entity should be treated in the same manner as if it were leased to a for-profit entity with reference to the availability to the owner of the I.T.C.

This provision would correct an inconsistency in the Code. Tax-exempt entities would be encouraged to use new equipment and hence increase the market demand and therefore the nation's productivity by receiving a lower lease fee, in the same manner that all other users are treated. A not inconsequential result of such a provision is that it would eliminate the confusing and costly process of establishing contracts for services instead of leases.

D. Protect Transactions Which Benefit Economically Distressed Communities

Property, used by tax-exempt entities, which is the subject of a sale-leaseback-type transaction which serves to benefit an economically distressed community should qualify for treatment under ACRS and I.T.C., regardless of size and of whether tax-exempt based financing is used.

This provision should apply in communities which meet the UDAG eligibility requirements. It is reflective of a sound national policy to aid such communities. Numerous revitalization projects in such communities have been and will be undertaken, if and only if, the tax benefits to the investors are available.

E. Create a Special Commission to Study Tax Treatment of Tax-Exempt Entities

In recent decades the number and range of activities by tax-exempt entities have mushroomed. At the same time, the even more recent interest in privatization has led to dramatic changes in perceptions as to what activities are appropriate to government and which to the private sector. The Code, IRS rules and regulations, and public perceptions have not kept pace with those revolutionary changes.

The most proper and productive response to the current wave of concern over "sale-leaseback" transactions would be to set up a special Commission to thoroughly review what tax-exempt entities are doing and how the tax system relates to their activities. Out of such a study can and should come carefully designed legislation that will prohibit sham transactions and will protect productive ones that inure to the nation's benefit.

III. PUBLIC POLICY CONSIDERATIONS

A. The Role of Non-Profit (Tax-Exempt) Entities in the Economic Life of the Nation

1. The Economic Contribution

The underlying rationale for tax code provisions such as "ACRS" and the Investment Tax Credit is that tax reductions in targeted areas will encourage economic growth. Growth results in an increase in the number of jobs and businesses and of taxable income to individuals and companies. Within a few years, so the Administration and Congress maintained, the economy's growth will generate far more taxable income and hence funds for the Treasury then will be lost through the various "incentives."

Assuming that this is a valid argument - it remains the President's basic economic position - the issue to be addressed is whether it applies to tax-exempt entities, as well as for-profit businesses. The most important answer to the query relates to the significant and growing role that tax-exempt entities play in the nation's economy.

In 1977, there were approximately 165,600 non-profit organizations in the United States responsible for expenditures totalling 85.4 billion dollars, including payroll costs of 41.7 billion dollars for 4.9 million employees. Projecting these numbers forward for 1982, non-profit organizations expended approximately 127.2 billion dollars, including payroll costs of 46.0 billion dollars for 5.5 million employees.

As this quick statistical look demonstrates, non-governmental tax-exempt entities are a major component of the national economic scene. Adding the thousands of local and state governmental entities, the millions of their employees, and the hundreds of billion of their expenditures in salaries and purchases (from for-profit business) leads to a clear picture. Tax-exempt entities are a major source of jobs and of business; they make enormous contributions to the national economy. Their expenditures lead to increased revenues for the Treasury, as the direct result of their economic activity.

Every time a tax-exempt entity proceeds to purchase new equipment, to construct a new facility, to redesign and rehabilitate an older facility, or to undertake other activities that involve capital expenditures, it contributes to the growth of the economy. It creates new jobs, it allows for a myriad of businesses to sell products and services, and it, therefore, feeds into the multiplier effect of capital expenditures. In other words, in economic terms, it acts and interacts in the economic system in the same manner as for-profit businesses.

2. The Impact of Public Incentives on Tax-Exempt Growth-Oriented Expenditures

Tax-exempt entities do not pay income taxes on "profits" or "retained income"; however, they do pay money to purchase goods and services and, in many cases, they derive income from selling goods and services. Like any other actor in the economic sphere, they are sensitive to relative marginal costs. They decide whether to expand their economic activity partially on the basis of the effective, bottom line costs. Of particular importance to them, as it is to all other rational economic actors, is the cost of funds necessary to make particular purchases. Such provisions of the Internal Revenue Code, as charitable contributions and tax-exempt financing - which create current losses to the Treasury - were designed to reduce costs to tax-exempt entities.

Another means for tax-exempt entities to reduce costs is their entering into Partnerships with private sector individuals and corporations. Through properly constructed Partnerships, the tax-exempt entity is enabled to share in the economic growth incentives contained in a variety of tax code provisions. These Partnerships, which must meet a complex of quite exacting IRS code provisions, regulations, and rulings, as well as the demands of the private investors' marketplace, involve a trading of funds, of rights, and of responsibilities. As with any Partnership, they require the tax-exempt entities to give up certain elements, such as ownership and total control, in order to utilize the property at a lower cost. The lower cost is possible because the for-profit Partners are able to derive full benefit from the economic growth-incentive tax code provisions and to anticipate other economic gains.

Therefore, Partnerships between tax-exempt entities and for-profit individuals or corporations provide a means for tapping the purchasing power of the tax-exempt entities and, thereby, promoting the Administration's basic economic plans for economic growth.

B. Partnerships - Private Sector Initiative and Privatization

In addition to the economic growth resulting from expenditures by tax-exempt entities which are made possible by the formation of Partnerships, these Partnerships further other important and basic goals of the nation. President Reagan has launched a major national campaign to encourage the Private Sector to become increasingly involved in activities, and support thereof, that had become dependent upon public funding. The President's Task Force on Private Sector Initiatives and the on-going White House Office on P.S.I. have led the way in identifying and promoting means for enhanced private sector participation. High among the list of recommended approaches are those of Public-Private-Non-Profit (or Community) Partnerships. and Privatization.

The infamous "sale-leaseback" technique is, in fact, nothing more than a component of one of these Partnerships. Where there is a true sale, or capital lease, and a true lease (not a hidden financing scheme), then the Partnership has been formed to carry out traditional business practices. It is, in effect, bringing to the tax-exempt world, the techniques and incentives of the business world. It provides a mechanism, wholly in accord with the Code and normal business practice, to encourage and facilitate private sector investment in a host of areas and activities that have been excluded from private sector participation in the past.

Tax-exempt entities are of two major types: governmental and private. In the case of the latter, these entities are a major part of the Private Sector. They perform a substantial role in reducing the dimension of the Public or Governmental Sector. As the President has said they provide a uniquely American way of meeting societal needs without expanding the freedom - threatening reach of the Government. Strategies and techniques, such as Partnerships including "sale-leasebacks," which strengthen the role of the non-profit institutions, which enable them to expand their activities and their positive contribution to the nation, are to be praised, not attacked as "drains on the Treasury." In addition to their positive impact on the nation's economy. such ventures add to the capability of the non-profit part of the private sector and hence to the nation's reservoir of freedom.

In the governmental sphere, these Partnerships and techniques, contribute yet another valuable element - privatization. One direct result of a sale-leaseback type of transaction is that property is moving from the public or non-profit sphere into the private for-profit sector. As ownership and its use are now under the control of private sector actors - the expansion of governmental powers has been curbed. Possibly, as important is the fact that once purely governmental activities are now subject to the demands and creative impact of the private sector.

C. An Issue of Equity-Equal Treatment for Private Non-Profit Entities

There is no rationale for treating private non-profit entities differently from profit-making entities in regard to the cost of the use of property. ACRS, investment credits of various kinds, lease and leveraged financing - these are practices that have been sanctioned because of their beneficial impact on the growth of the nation's economy. As we have shown, they can work to promote such objectives regardless of whether the property in question is used by a for-profit or a not-for-profit entity. In both cases, they serve to reduce costs and thereby as an incentive for economic activity that leads to jobs, increased business activity, a healthier economy, and higher tax revenues.

By restricting the ability of non-profit entities to share in the benefits of ACRS and the I.T.C., one is arbitrarily increasing the relative cost of the use of the property to the non-profit. This is a patently unfair policy. It is also unwise as it will lead to two very undesireable results: (1) the need for substantially increased federal government expenditures; and (2) a weakening of the non-profit private sector.

If the Congressional concern is with a drain on the Treasury then the answer must be to conduct a study of the short-term loss versus the long-term gains of increased economic activity generated by these tax incentive measures - a study that should be conducted for the for-profit business side as well. If the concern is with the prevention of sham transactions, then the answer must be to analyze the current IRS practices and requirements (see below) to determine if they are adequate or not -- an analysis that should be for all types of entities, not just for those in the non-profit sector. As currently constructed, S.1564 and H.R. 3110 is an attempt to unfairly constrain the resources of the non-profit entities and in direct conflict with the Administration's expressed policies.

D. Placing the "Sale-Leaseback" Transactions in Perspective

1. Number and Size of Transactions

An enormous drain in the Treasury, or so we are told, is already occurring through the use of "sale-leaseback" transactions by tax-exempt entities. Are there any figures on currently completed transactions? Are there any realistic projections of lost tax revenues? Are their any analyses of types and categories of transactions and whether there are differential impacts on tax revenues? Are there any studies of economic growth and increased tax revenues resulting from such transactions - The plain answer is no. No hard facts are available.

An uninformed, legislative branch hysteria - joined in by equally uninformed newspaper press coverage created an irrational climate for consideration of whether tax law changes are really needed.

As the section below demonstrates, sham transactions are already the target of any number of IRS provisions and regulations. ACRS is already not available for pre-1981 properties owned or used by an entity that will be leasing it back - therefore, S. 1564 and H.R. 3110 are irrelevant in this regard, to most real property moved by tax-exempts. They place a more restrictive 40 year or 35 year rule on property which may actually have a much shorter useful life.

All transactions must be based on economic factors other then tax considerations and must reflect changes in ownerships and control in substance as well as in form.

What is wrong with a group of private investors entering a transaction with a private college that results in the construction of new residential units that are leased to students? Why is it a perversion to permit a museum to sell its decayed building to a group of investors who are willing to put up the funds, and assume the risk of financing its rehabilitation, and then lease it to the Museum to operate? What is so terrible about a private school's selling a building to a group of investors who will turn it into a Community-wide performing arts center or a sports facility or a conference center and contract with the school to operate it? Why it is wrong for a computer services company, together with a partnership of private investors, to enter a contract to provide the services of personal computers and a mainframe to the students, faculty, and administrators of a college? For that matter, what is the economic rationale for denying the investment tax credit to investors when they purchase new equipment and lease it to a non-profit? These are the targets of S.1564 and H.R. 3100 - what is the evidence that would support such an attack? It does not exist.

2. The Current Tax Law: Adequate Protection

There has been a substantial amount of litigation, followed by revenue rulings,* which seek to enumerate when there is a genuine multiple party transaction with economic substance, independent of tax avoidance features, which should be viewed as a "true lease" between the parties and vest an ownership interest in the lessor. The proposed legislation does not simplify or clarify the existing framework for evaluating the tax worthiness of a sale-leaseback transaction but complicates the entire field by creating a new class of property called "tax-exempt use property" and treating such property in an abritrary manner not related to economic realities. This legislation will cause unnecessary rulemaking, litigation, and judicial construction.

**See*, *e.g.*, *Frank Lyon Co. v. United States*, 435 U.S. 561, 98 S. Ct. 1291, 78-1 U.S.T.C. ¶9370 (1978), *rev'g* 535 F.2d 746, 76-1 U.S.T.C. ¶9451 (8th Cir. 1976); *Estate of Franklin v. Comm'r.*, 544 F.2d 1045, 76-2 U.S.T.C. ¶9773 (9th Cir. 1976), *aff'g* 64 T.C. 752 (1975); *Carol W. Hilton v. Comm'r.*, 74 T.C. 305 (1980), *aff'd per curiam*, 671 F.2d 316, 82-1 U.S.T.C. ¶9263 (9th Cir. 1982); *Fortune Odend'hal, Jr.*, 80 T.C. No. 29, CCH Dec. 39,992 (March 28, 1983); Rev. Proc. 75-21, 1975-1 C.B. 715; Rev. Proc. 75-28, 1975-1 C.B. 752; Rev. Proc. 76-2, 1976-2 C.B. 647.

IV. Provisions of S.1564 - Responses and Changes

A. The Bill's Heading

The stated purpose, "to deny certain tax incentives for property used by governments and other tax-exempt entities", is directed at the wrong problem. The purpose should be to prevent sham transactions but not to deny the use of the tax incentives for the reasons stated in Part III above.

B. Tax-Exempt Use Property - Section 2 - "(13)(C)(i)"

ACRS was instituted to encourage more investments and capital expenditures by permitting a quicker recovery of such costs. Investors willing to put up capital for property which generates income through a lease to tax-exempt entities should be entitled to ACRS. The fact that tax-exempt entities are users is totally irrelevant to the underlying rationale of ACRS.

C. 15-year Real Property - Section 2 - "(13)(C)(iv)"

ACRS should be denied in those cases where the property was sold or leased by a tax-exempt entity to a taxable person(s) solely for purposes of "cashing out the equity". In keeping with the economic growth basis of ACRS, the proper test ought to be whether the transaction involved the expenditure of new capital in order to create new jobs, businesses, and/or to improve an existing capital asset. Transactions involving new construction, significant rehabilitation (no less than 25% of the base cost of the building), and purchase of new equipment should be presumed to be economic growth contributions so that such property would be entitled to ACRS treatment. On the other hand, transactions such as the sale and leaseback of an existing building, which involve no significant physical improvements, should be excluded for ACRS treatment.

The definition of "tax-exempt use property" to include any property leased by a tax-exempt entity for a period which is greater than ten years appears arbitrary and represents one unnecessary intrusion by Congress into the private market-place. To create such an artificial deadline for leasing transactions involving tax-exempts will seriously harm the real property developers and owners and lead to higher costs for non-profits.

D. Service Contracts - Section 2 - "(13)(F)"

S.1564 is vague on what is meant by the phrase "such entity controls or is in physical possession of the property. The key issues pertaining to the difference between a service contract and a lease are those which have been carefully explained and enumerated by the Court of Claims in Xerox Corporation v. United States, 656 F. 2d 659 (1981). The language of S.1564 will only serve to muddy the waters.

Congress can easily clarify the law in this area by taking the following two actions:

1) Prohibit federal governmental entities from entering into lease or service contracts unless such action is pursuant to specific Congressional authorization and appropriate language.

2) Permit the investment tax credit (I.T.C.) to owners of personal property which is leased to tax-exempt entities.

E. Rehabilitation Expenditures - Section 2 - "(b)(2)(A)(11)"

Congress wisely acted to include property used by non-profit and governmental entities in the rehabilitation tax credits. Such entities are often the major users of these properties. In many cities and neighborhoods, they are the current owners but lack the funds necessary for proper rehabilitation of these valuable national resources. Literally hundreds of physical redevelopment projects, involving the expenditure of millions of private dollars, the creation of thousands of jobs, and the saving of scores of old, fine properties that reflect the nation's past and protect its future, are economically feasible only because of these credits. To deny them is to sound an end to the hope of rebirth for many of our nation's museums, colleges, cities, towns, neighborhoods, churches and hospitals. S.1564 should be amended so that rehabilitation investment credits are allowable with respect to tax-exempt use property.

V. PROVISIONS OF H.R. 3110 - RESPONSES AND CHANGES

A. The Bill's Heading

The stated purpose, "to deny certain tax incentives for property used by governments and other tax-exempt entities", is directed at the wrong problem. The purpose should be to prevent sham transactions but not to deny the use of the tax incentives for the reasons stated in Part III above.

B. Tax-Exempt Use Property

Section 1(a)

The term "tax-exempt use property" (Section 1,(a)) ought not to be in the legislation as it unfairly establishes a differentiation in categories of property based solely on use by a tax-exempt entity. There is no rationale for this classification, in fact, it works against economic growth incentives and the economic viability of the tax-exempt entities in the non-profit sector. The proper term would be "abusive use of tax incentives" by anyone.

C. Recovery Period

Even if ACRS is to be denied, the "recovery period" (Section 1(a)) should reflect actual years of use and not a predetermined penalty on tax-exempt entities. Some personal property, e.g., computers and other highly sophisticated equipment where technological breakthroughs are common, does have a 3 year useful life. As for real property, an older used, not substantially rehabilitated building might only have a 15 to 20 year useful life. To establish rigid categories is to be arbitrarily hostile to tax-exempt exempt entities.

D. Real Property Exclusions

Tax-exempt financing under Section 103 of the Internal Revenue Code is already a very restricted source of financing when private investors are to be involved. By further extending these restrictions, the legislation will primarily harm small non-profit institutions. Because of the limited size of permissable transactions under current legislation ($1,000,000), the potential loss to the Treasury is minimal.

Provisions II and III are merely partial restatements of the existing law regarding what is a true sale and/or lease. All transactions must place the tax payer at risk and must provide for fair market value prices for a purchase under a lease option. The proposed language serves only to confuse the situation as it is not a full restatement of existing law and could be easily misinterpreted.

Provision IV, seems to be a general prohibition against sale-leaseback transactions. It seems appropriate to prohibit ones where there is no economic justification, as the current law does. It also seems appropriate to prevent "churning", as the current law does for pre-1981 property. Therefore, language which established a presumption against sale-leaseback in cases where there was no new construction, significant renovation, or substantial change of use connected with the property in question might be justifiable.

E. Categorization of Tax-Exempt Entities

In terms of public policy considerations, there should be distinctions made between types of entities: (1) federal government; (2) state and local government; (3) non-profit public entities; and (4) non-profit private entities. The case for protecting the ability of the entity to participate in Partnerships with private investors, to engage in sale-leaseback transactions, and to contribute to the nation's economic growth appears to get stronger as the focus moves down the list of types of tax-exempt entities. Lumping them all together reflects a lack of sensitivity to the separable issues at hand and to the damaging impact on the non-profit entities, which lack the power of self-financing or of a direct federal appropriation.

If Congress is concerned about its own creations and subjects, then it should so specifically legislate. It might legitimately view the sale and leaseback of U.S. government property, such as satellites, as inappropriate and dangerous. It could view the Navy Ships deal as an effort to circumvent the normal appropriations process. It may oppose privatization of federal activities. In each case, it can do so without unnecessarily crushing the initiatives of other parts of our pluralistic nation.

F. Contracts for Providing Services

The issue of when the provision of use of certain equipment is a lease or a contract for services is a complex one. It is a matter of some conflict between the IRS and the Court of Claims. The proposed legislation simply restates the problem. It would be preferable for Congress to seriously review the whole matter. We believe that the current prohibition against taking the I.T.C. on equipment leased to a tax-exempt entity is not in accord with the rationale behind the I.T.C. in general.

G. Rehabilitation and Tax-Exempt Bonds

If a project meets the careful and severe constraints of Section 103, and the demanding ones of Section 48 (rehabilitation tax credit), then there is no rationale for denying the use of either of the provisions. Once again, tax-exempt entities serve to meet the purpose of preserving and encouraging investment in older properties just as do tax paying ones. There is no basis for discriminatory treatment.

aamc association of american medical colleges

July 26, 1983

The Honorable Robert Dole
Chairman, Committee on Finance
U. S. Senate
141 Hart Senate Office Bldg.
Washington, D. C. 20515

Dear Mr. Chairman:

The Association of American Medical Colleges (AAMC) wishes to convey its views for the hearing record on S. 1564, the "Governmental Lease Financing Reform Act of 1983." The Association's constituency includes all U.S. medical schools, 74 academic societies and more than 425 of the nation's major teaching hospitals. These are public (e.g., governmental) and private, not-for-profit--IRS 501 (e)(3)-- institutions. Together the AAMC membership is responsible for: the training of most of the nation's medical manpower at all levels of the health sciences; the conduct of much of the nation's basic and applied biomedical research and technology development; and the complex and highly sophisticated care of the nation's most seriously ill patients. Moreover, the teaching hospital members provide a disproportionate share of the charity and uncompensated patient care provided by all hospitals nationally. In recognition of their important public purpose activities, the federal government exempts these not-for-profit institutions from federal taxation. Additionally, the AAMC believes these entities should not be prohibited from productive uses of certain tax policies designed to benefit taxable entities because of the indiscretions of a few.

While the AAMC appreciates the intent of this legislation, it notes that neither a hospital nor a medical school was cited among the examples of questionable sale-lease back arrangements which prompted the introduction of S. 1564. We believe that the bill takes too broad a brushstroke and would restrict not only such abuses, but also legitimate and productive uses of leasing transactions between tax-exempt organizations and taxable lessors. Specifically, as you acknowledged in your introductory remarks on the bill, there is need to insure that leases of high technology medical equipment are treated properly and that the restrictions related to real property and the rehabilitation tax credit do not go beyond preventing the abuses targeted.

Many tax-exempt hospitals and medical schools are facing serious cash flow and credit problems. Prudent managers at tax-exempt facilities have long used lease transactions to acquire, in the most cost-efficient manner available, the use of needed equipment and property that would otherwise not be readily affordable. Such financing shifts the obsolescence risk to the lessor, for whom the risk is at least partially offset by the tax advantages provided under ACRS.

As presently written, S. 1564 would replace the accelerated cost recovery system (ACRS) with Asset Depreciation Range (ADR) midpoint lives in the tax treatment of high-tech equipment. However, the Senate bill provides that if such property has a class life under the ADR system of 6 years or less and is leased for a term not in excess of 75% of that life, the property is generally exempt from the bill.

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Though this is a marked improvement over the restrictions of the proposed House bill (H.R. 3110), it may still be too restrictive in light of the rapid technological obsolescence of such equipment.

It has been estimated that the elimination of ACRS under S. 1564 will result in a 10 to 15 percent increase in the cost of leasing new medical equipment. These costs will create higher health care costs which payers, such as Medicare, will have to share the burden of meeting. Such an outcome would be counter-productive to the efforts to reduce health care cost escalation. In certain cases, rents could become so prohibitively expensive so as to preclude the lease acquisition of needed medical equipment entirely. Clearly, the public interest would not be served well by such negative effects. Furthermore, there has been no suggestion that leasing of new medical equipment or other short-lived property has been abusive of tax policy. Therefore, the AAMC calls for the exemption of such lease transactions from S. 1564 when they involve tax-exempt, public purpose entities such as hospitals and academic institutions.

With respect to real property used by a tax-exempt entity, S. 1564 is more stringent than its House counterpart and would require straight-line depreciation over the greater of 40 years or 125 percent of the lease term, rather than ACRS over 15 years. Additionally, a separate provision of the bill would deny the rehabilitation tax credit in any case in which there is a tax-exempt user. The AAMC contends that these provisions would unintentionally prohibit many worthwhile and productive transactions by tax-exempt entities that would be in the public interest and serve the capital formation objectives of ACRS.

An example of such a meaningful use would be the university academic medical center which sells a 50-year-old building to a private developer at fair market value. The building is renovated by the developer at the cost of several million dollars and leased back to the university at a fair rental value. The university did not have sufficient capital to undertake this needed renovation itself. As presently drafted, S. 1546 would require the taxable purchaser-lessor to deduct its rehabilitation expenditures on a straight-line method over a 40-year period, rather than under ACRS over 15 years. Clearly, the legislation would reduce the attractiveness of such a purposeful arrangement without regard to its economic substance or objectives. Therefore, we urge Committee members to modify S. 1564 with explicit language that will distinguish such positive transactions from the self-serving, unproductive ones which this legislation specifically seeks to eliminate.

Thank you for your consideration of these concerns.

Sincerely,

John F. Sherman, Ph.D.
Vice President

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MEMBERS OF THE N. Y. BAR
*ALSO MEMBER OF THE D. C. BAR
**MEMBER OF THE D. C. BAR ONLY

July 19, 1983

By Hand

The Honorable Robert J. Dole
Chairman
Committee on Finance
215 Dirksen Senate Office Building
Washington, D.C. 20510

Re: S. 1564 - Transition Rule

Dear Mr. Chairman:

This letter is submitted on behalf of Singapore Airlines, Inc., a foreign international airline which flies regularly between the Far East and United States airports in Hawaii and the West Coast. We respectfully request that this letter be included in the printed record of the hearings to be held on July 19, 1983, before the Committee on Finance on S. 1564, the "Governmental Lease Financing Reform Act of 1983." Although we are strongly of the view that extension of the provisions of S. 1564 to foreign lessees not subject to tax in the United States is inappropriate, and that the consequences of doing so have not been duly analyzed and considered, this letter will focus only on the need for more equitable transitional rules.

The transitional provisions of S. 1564, as introduced, fail to extend appropriate "grandfather" treatment to certain leasing transactions with respect to property that was subject to binding written contracts prior to the bill's proposed effective date of May 23, 1983. As explained below, the transitional rule of S. 1564 appears to omit protections normally afforded by the Congress to persons, such as Singapore Airlines, who have entered into binding commitments in reliance on the law which was in effect when their contracts were executed, and for which no legislative changes had been proposed. We urge that the transitional rules be expanded to provide customary protection to persons who made binding commitments in reliance on the present leasing provisions prior to May 24, 1983.

Background

Singapore Airlines, as lessee, has recently consummated U.S. leveraged leases for two U.S.-manufactured commercial Boeing 747-300's. The first aircraft was delivered on June 21, 1983 and the second on June 30, 1983. Prior to the introduction of H.R. 3110, the House companion bill to S. 1564, on May 24, (1) a binding purchase contract for the two planes had been in effect for over a year; (2) the major terms of both lease transactions had been settled with equity investors; (3) voluminous documentation had been drafted, circulated and revised, and was in the process of negotiation; (4) a crucial Federal Aviation Administration ("FAA") exemption for U.S. registered aircraft operated by a foreign airline had been obtained; and (5) the airline, as well as the equity investors, had incurred substantial transaction costs. Moreover, by May 24, the airline, relying reasonably on the U.S. tax law in effect, had effectively sacrificed other potentially advantageous financing arrangements to pursue the U.S. lease financings.

Although the purchase contract for the two aircraft had long been binding, the necessary FAA exemption had been obtained, and the lease documentation was substantially completed by May 23, as is typical in lease transactions, a binding commitment to lease was not executed. The absence of a binding commitment to lease appears to exclude the leasing transactions described above from the binding contract rule of S. 1564, notwithstanding the existence of a binding contract for the acquisition of the aircraft and the substantial commitments to lease made by the airline. (Bill Section 2(d)(2)(B)).

Analysis

The binding contract rule's double-commitment requirement would unfairly penalize many typical transactions. Any substantive changes in the taxation of leasing activities should "grandfather" all lease transactions of equipment acquired pursuant to binding purchase agreements in effect on May 23, 1983, where the lessee is the party that was bound to acquire the equipment under the purchase agreement. See, e.g., former Section 49(b)(5) of the Code. It is well recognized that the availability of leasing under favorable tax law provisions serves to induce persons who cannot take advantage of capital formation tax incentives directly to make purchase commitments for equipment. Thus, for example, when the safe harbor leasing provisions were substantially changed by TEFRA, transitional rules were provided which looked to the lessee's commitment to acquire or construct the property and not to the existence of a contract to lease. (See Tax Equity and Fiscal Responsibility Act of 1982, Section 208(d)(2)-(6).) Considerations of fairness require similar principles to be adopted here.

If Congress decides not to "grandfather" all equipment subject to binding purchase commitments as of May 23, 1983, however, it would be appropriate to adopt a special "grandfather" rule for all commercial aircraft that were subject to purchase commitments binding on the lessee as of May 23, 1983. This can be justified on the basis of special factors applicable to commercial aircraft. The availability of a U.S. lease financing option (under current tax rules) has been particularly important to foreign airlines over the years in committing to the purchase of U.S.-manufactured aircraft. This consideration is magnified by the favorable financing options often made available in connection with sales of foreign made aircraft. Thus, it is more clear that foreign airlines have relied on the availability of U.S. leveraged lease financing in committing to purchases of U.S.-manufactured aircraft than it is with respect to other types of property.

If Congress wishes to impose a reasonable outside date on when the "grandfathered" aircraft could be placed in service, we would suggest December 31, 1983. This should still place aircraft leasing transactions that had reached significant levels of planning as of May 23 -- such as the two transactions described above -- under present law. As described above, these cases involve substantial costs and other financial commitments incurred by May 23, and without transitional rule protection, the lessees would be seriously injured.

We believe that a December 31, 1983 "placed-in-service" date requirement is necessary to protect foreign airlines that already had substantial leasing activities under way on May 23 (although a June 30th cutoff date is all that is required to protect the two Singapore transactions referred to above). The amount of lead time required for a foreign airline to consummate a U.S. leveraged lease is strongly evidenced by required FAA submissions. For example, to avoid the need to comply with burdensome equipment requirements that would otherwise apply to foreign carriers operating U.S. registered aircraft, an FAA exemption must be obtained. An application for such exemption must be filed at least 120 days prior to the start of operations. At the same time, substantial other documentation needs to be prepared for filing. These activities entail substantial legal costs and involve a significant number of FAA staff hours. Thus, airlines file such applications only when a firm decision has been made to pursue a U.S. leasing arrangement. A copy of the FAA grant of exemption to Singapore Airlines in connection with the two transactions referred to above is attached for your information.

When one takes into account the time necessary to consider financing options, talk to prospective equity investors and others, decide to go forward with a U.S. leveraged lease transaction and complete the necessary preparations for filing an application for FAA exemption at least four months in advance of scheduled delivery, it is reasonable to assume that any aircraft placed in service in 1983 under a U.S. leveraged lease to a foreign airline was the object of substantial economic commitments to lease by May 23, 1983.

Respectfully submitted,

Richard M. Leder

Richard M. Leder, Esq.

Michelle P. Scott

Michelle P. Scott, Esq.

Exemption No. 3768

UNITED STATES OF AMERICA
DEPARTMENT OF TRANSPORTATION
FEDERAL AVIATION ADMINISTRATION
WASHINGTON, D.C. 20591

In the matter of the petition of

SINGAPORE AIRLINES

for an exemption from § 21.181 of
the Federal Aviation Regulations

Regulatory Docket No. 23521

GRANT OF EXEMPTION

By letters dated February 4, and April 28, 1983, William C. Clarke, Esquire and Joanne W. Young, Esquire with Barrett, Smith, Schapiro, Simon and Armstrong, 1201 Pennsylvania Avenue, N.W., Washington, D.C., petitioned on behalf of Singapore Airlines (SIA), for an exemption from § 21.181 of the Federal Aviation Regulations (FAR) to operate two leased, U.S.-registered Boeing 747-300 Stretched Upper Deck (SUD) aircraft, Serial Nos. 23027 and 23028, utilizing a Federal Aviation Administration (FAA)-approved minimum equipment list (MEL).

Section of the FAR affected:

> SIA's operation is governed by the following regulation which does not permit the use of an MEL.
>
> Section 21.181, which provides, in pertinent part, that an airworthiness certificate is effective so long as the maintenance, preventive maintenance, and inspections are performed in accordance with Parts 43 and 91.
>
> This provision prohibits the operation of an airplane with either inoperable items of installed equipment or missing items of required equipment. With respect to equipment required under an aircraft type certificate, the supplemental type certification procedures of Part 21 provide a means to change the type certificate to permit operations with inoperable or missing equipment. Since SIA is not a Part 121 certificated air carrier, it is not required to meet the additional equipment requirements of Part 121 and is, therefore, not authorized to use the MEL. However, operations by SIA with equipment required by Part 121 installed, but inoperable, would be prohibited under Part 91.

The pertinent information provided by petitioner is as follows:

> SIA is a foreign air carrier which holds operations specifications under Part 129 of the FAR. The aircraft will be purchased new by U.S. financial institutions, under assignment of the present SIA purchase contract with Boeing Commercial Airplane Company. Simultaneously, the financial institutions, acting as trustee and lessor, will lease the aircraft to SIA pursuant to net lease agreements for 12 to 15 years. Copies of the lease will be provided to the FAA as soon as the lease is executed. The owner will apply for U.S. registration of the aircraft in due time, related to the scheduled delivery dates in June 1983. The aircraft will be operated on international flights by airmen currently employed by SIA who possess the requisite airman certificates issued by the Republic of Singapore Civil Aviation Authority (CAA) and who will possess properly issued FAA airman certificates.
>
> SIA understands that the effectiveness of its exemption authority will be conditioned on its application for, and the issuance of, special-purpose airman certificates pursuant to §§ 61.77 and 63.23 of the FAR.
>
> Under the terms of the lease, SIA will be required to maintain the aircraft in accordance with all FAA requirements and in compliance with all applicable laws and regulations. Furthermore, under the lease terms the maintenance standards cannot be below those applied to similar aircraft owned or leased by SIA.
>
> SIA currently utilizes, with minor changes, the Boeing-recommended continuous airworthiness maintenance program for its B-747 fleet. This program is the same as those U.S. air carriers are authorized to utilize under Part 121. SIA will submit its B-747 maintenance program to the FAA Air Carrier District Office in Burlingame, California, for approval.
>
> SIA currently holds U.S. Foreign Repair Station Certificate No. 661-34F (issued November 29, 1982), for its Singapore maintenance base. The application was processed by the FAA's Honolulu office, and the Operations Specifications of the certificate carry the necessary overall ratings. At all U.S. line stations, SIA contracts out B-747 maintenance work to air carriers holding U.S. Repair Station or Foreign Repair Station Certificates who will perform all maintenance on the aircraft in accordance with the SIA maintenance program approved by the FAA Air Carrier District Office in Burlingame, California.
>
> At the Honolulu line station, Canadian Pacific Air performs SIA's maintenance work; while at Los Angeles, Trans World Airlines performs the maintenance for SIA's operations. At the San Francisco line station, maintenance work is performed by Quantas Airways and Servair of California. All such maintenance is performed under the direct supervision of a resident SIA maintenance supervisor authorized under § 43.3 to perform maintenance, preventive maintenance, rebuilding, and alterations, and § 43.7 to approve the aircraft for return to service. While the aircraft will be predominately operated between Singapore and the above-referenced U.S. destinations, in the event the aircraft does go to other stations, SIA states that line maintenance will be done in accordance with the SIA maintenance program approved by the FAA Air Carrier District Office in Burlingame, California.

SIA's use of an FAA-approved continuous airworthiness maintenance program is necessary to facilitate international leasing of U.S.-registered aircraft, and will promote safety and efficiency in air transportation.

The operational requirements of the Republic of Singapore CAA, under which SIA operates its present B-747 fleet, are similar, if not identical, to the requirements for U.S. air carriers under Part 121. Considering this similarity and the fact that SIA will be responsible under the lease for maintaining and operating the aircraft in an airworthy condition under FAA standards, SIA respectfully requests exemption from the procedural requirements of Part 21 to enable it to obtain, by means of the exemption, a supplemental-type certificate covering the operation of the aircraft using the SIA B-747 MEL approved for use by SIA. The SIA MEL is substantially in accordance with the FAA-approved master minimum equipment list (MMEL) for the B-747.

An exemption enabling SIA to operate the leased aircraft using the FAA-approved MEL is necessary to avoid an undue burden on SIA with respect to the leased aircraft which would have a detrimental effect on international leasing of U.S.-registered aircraft. The exemption will also promote safety by ensuring common operational and technical standards for SIA's B-747 fleet.

SIA states it would like to perform preflight inspections and minor maintenance (line maintenance) at outlying stations located outside the United States, using its own personnel specified in its Foreign Repair Station Certificate (No. 661-34F, issued November 29, 1982). This is permitted under §§ 145.77 and 145.51(d).

SIA states it needs the flexibility of sending mechanical personnel to perform or supervise routine inspection and line maintenance at stations in 36 cities served by SIA. Work would be performed under the authority of its Singapore maintenance base, a certificated Foreign Repair Station. The operations specifications of this certificate carry the necessary overall ratings. Work would be performed entirely by personnel of other carriers under the supervision of SIA personnel.

SIA states it will insure that the requirements of §§ 145.77 and 145.51(d) are fulfilled. All work will be performed and aircraft returned to service in accordance with SIA's continuous airworthiness maintenance and inspection program and the operations specifications of the Foreign Repair Station Certificate. SIA will further insure that all work performed at its outlying stations will conform to the same high standards of safety and quality control as are followed at the maintenance base in Singapore. All work will be performed by personnel assigned to the main base, or having the same high qualifications, and who will hold all appropriate mechanics licenses issued by the Republic of Singapore.

SIA states that the FAA recently approved a similar proposal for Japan Air Lines (Exemption No. 3664, December 1, 1982). SIA has been in contact with the FAA office in Honolulu, and understands that office will work out the appropriate modifications to SIA's Foreign Repair Station Certificate operations specifications, when notified of the approval of FAA's action on the company's petition.

> SIA understands that while an exemption from the provisions of § 61.77 and § 63.23 is not necessary to operate the leased aircraft, the effectiveness of the exemption authority applied for herein will be expressly conditioned on the issuance of special purpose airman certificates under the procedures set forth in those sections. To this end SIA pilots and flight engineers will submit applications for the special purpose certificates through the FAA's Air Carrier District Office in Burlingame, California, on the basis of airman certification standards of the CAA which meet or exceed the International Civil Aviation Organization's (ICAO) standards in all respects. SIA understands that compliance with ICAO standards is a prerequisite to the mutual obligation to recognize certificates of competency and licenses issued by the parties to the Air Transport Agreement between the Republic of Singapore and the United States.
>
> SIA hereby assures the FAA that it will obtain physical possession of the special purpose airman certificates to be issued under § 61.77 or § 63.23 from SIA flight crewmembers who hold the certificates upon (a) termination of the lease agreement; (b) suspension, revocation, or invalidity of their foreign pilot certificate or license or their medical documentation; (c) the date on which a holder of a pilot certificate reaches the age of 60; or (d) termination of their employment as airmen by SIA for any reason.
>
> The exemption requested in this petition will enable SIA to continue the commonality and standardization of its fleet and will promote the safety of its system-wide operations to an equal or greater extent than the rules from which an exemption is sought. Moreover, and as the FAA previously determined in Exemption No. 3044, petition of the Department of International Affairs of the General Administration of Civil Aviation of China and Pan American World Airways, Inc., (Docket No. 20779), the granting of the exemption will be in the public interest by facilitating international leasing of U.S.-registered aircraft which expands the utility of such aircraft, promotes trade, helps to stabilize the balance of payments, and otherwise improves the foreign relations of the United States.

A summary of this petition was published in the Federal Register on March 3, 1983 (48 FR 9118). No comments were received.

The FAA's analysis/summary is as follows:

> The FAA has determined that the operation of the Boeing 747-300 (SUD) aircraft, Serial Nos. 23027 and 23028, by SIA under an FAA-approved MEL for those aircraft in conjunction with an FAA-approved maintenance and inspection program will provide a level of safety equal to that provided by the rules from which an exemption is sought.
>
> The FAA has further determined that a grant of exemption is in the public interest because the leasing of U.S. aircraft improves relations with foreign governments, develops trade, and helps stabilize the balance of payments in favor of the United States.

In consideration of the foregoing, I find that a grant of exemption is in the public interest. Therefore, pursuant to the authority contained in Sections 313(a) and 601(c) of the Federal Aviation Act of 1958 (the Act), delegated to me by the Administrator (14 CFR 11.53), and Section 603 of the Act, Singapore Airlines is granted an exemption with respect to the Boeing 747-300 (SUD) aircraft, Serial Nos. 23027 and 23028, as follows:

From the procedural requirements of Part 21 of the FAR to the extent necessary to permit SIA to obtain a supplemental type certificate covering the operation of Boeing 747-300 (SUD) aircraft, Serial Nos. 23027 and 23028, in accordance with an FAA-approved MEL for the aircraft. This exemption, together with an FAA-approved MEL, constitutes a supplemental type certificate for the aircraft for the duration of the exemption, subject to the following conditions and limitations:

1. The use of the maintenance and inspection program and the airline MEL, based on the B-747 MMEL, must be submitted to the FAA Air Carrier District Office, Burlingame, California, for approval by the FAA. The petitioner must obtain from that office, prior to commencing operations under its MEL, a letter of authorization for operation of the aircraft using an FAA-approved MEL. All maintenance must be performed by persons authorized in accordance with § 43.3, and the aircraft must be approved for return to service by persons authorized by § 43.7.

2. A copy of the approved MEL for each aircraft, as appropriate, a copy of this exemption, and a copy of the letter of authorization for operation of the aircraft using the FAA-approved MEL must be inserted into the airplane flight manual of each airplane and carried in the airplane while it is being operated. These documents shall be presented to representatives of the Administrator for inspection upon the request of such representatives.

3. The maintenance of the U.S.-registered B0747-300 (SUD) aircraft, operating through line stations on the SIA route structure outside the United States, shall be conducted in accordance with the limitations outlined in the SIA Repair Station Operations Specifications, FAA Form 8000-4-1, as amended.

4. SIA must comply with the requirements applicable to the holder of a supplemental type certificate as contained in Part 21 of the FAR, including the failure, malfunction, and defect reporting requirements of § 21.3.

5. Each flight crewmember operating under this exemption shall possess either an appropriate U.S. airman certificate or a special-purpose U.S. airman certificate with pertinent ratings, issued under § 61.77 or § 63.23 of the FAR, whenever performing flight crewmember duties on the aircraft. A copy of this exemption and a valid U.S. airman certificate shall be presented to representatives of the Administrator for inspection upon request.

This exemption terminates on May 31, 1985, unless sooner superseded or rescinded, or upon expiration of either lease agreement with respect to Boeing 747-300 (SUD) aircraft, Serial Nos. 23027 and 23028, whichever occurs first.

KENNETH S. HUNT
Director of Flight Operations

Director of Flight Operations

Issued in Washington, D.C., on MAY 20 1983

STATEMENT
OF
CITY OF PHILADELPHIA

BEFORE THE

SENATE FINANCE COMMITTEE

HEARINGS REGARDING S. 1564
GOVERNMENTAL LEASE FINANCING
REFORM ACT OF 1983

July 19, 1983

Rodney D. Johnson
Managing Director
City of Philadelphia
Municipal Service Building
Philadelphia, Pennsylvania 19107

Mr. Chairman and Members of the Committee:

I am Rodney D. Johnson. As the Managing Director and former Director of Finance for the City of Philadelphia, Pennsylvania, my responsibilities include capital budgeting, all of the city's debt financing, and financing of public and joint public-private development projects, including projects that make use of the leasing and financing opportunities created by the Economic Recovery Tax Act of 1981 ("ERTA").

I. Philadelphia's Economic Development Efforts.

The City of Philadelphia has many problems typical of aging Northeastern United States cities. The city's population and economic base and, hence, its tax base have shrunk. Yet, it must serve its citizens who include a disproportionate number of the aged and poor who are heavily dependent on city services. At the same time, the city's major capital assets -- roads, transit system, water and sewer system, port facilities, airports, prisons, and utilities -- are aging rapidly and require major maintenance expenditures or substantial new investment.

Much of this investment and other funding comes from traditional private and government sources. Utilizing these sources, the city is attempting to rebuild its economic base with projects such as Penn's Landing, a major commercial and residential development on the downtown waterfront, estimated to generate 3,650 jobs; Market East, the redevelopment of twelve blocks of downtown Philadelphia into a major retail, office, and transportation center, including the precedent-setting urban shopping malls, Gallery I and Gallery II, with 3,825 direct jobs and 3,442 indirect jobs; and the Center City Commuter Tunnel, which will link the two major commuter rail systems in the center of the city, generating 1,590 construction jobs. Innumerable smaller projects are underway in the city's neighborhoods and commercial strips. The city is also currently in the planning phase of a new convention center which will directly generate an estimated 9,000 new jobs. It is our expectation that these projects, along with improvements to our infrastructure systems, will revitalize the city.

II. Institutional and Legal Limitations on Philadelphia's Capital Investment Efforts.

The underlying limitation on our ability to carry these projects forward is capital investment. In order to bring these projects, which represent anchors for economic growth, on-stream, the city must attract private and public sector investment. Yet, just when our need is greatest, we find the supply of funds diminishing and the cost increasing.

There is no need to describe in detail the rise in interest rates which hamper the city's ability to borrow. Even with the relief of recent rate declines, we find the cost of borrowing is nearly double that of ten or fifteen years ago. Further, the looming federal deficits are anticipated to drive the demand for credit and interest rates to new all-time highs.

The city also faces a statutory debt limit imposed by the Constitution of the Commonwealth of Pennsylvania. Thus, even if the city could afford to borrow at any interest rate, it is limited to a fixed amount of general obligation bond financing outstanding at any one time. This cap is currently $60 million.

Finally, federal funding has been a useful and valuable supplement to the city's direct investment. We are grateful for such funding which has helped finance our airports, roads, transit system, water and sewer system, housing, and economic development projects. Yet, again, when our need is greatest, we see the federal government cutting back on its commitment to share in the necessary costs of maintaining a viable and livable metropolitan area.

III. Importance to Philadelphia of Financing Opportunities Created by Economic Recovery Tax Act of 1981 and Description of Certain Key Projects Utilizing Tax Incentives.

One of the last remaining available sources of capital has been the private sector. Some of the aforementioned major development projects were only possible due to close working relationships with, and direct contributions by, private corporations. These investments do not come from a sense of charity, or solely from a public commitment to urban development by private industry. Instead, they are made because they offer a fair and competitive return.

One of the factors that make such critically needed investments attractive in the highly competitive money market is the leasing and financing opportunities created by the Economic Recovery Tax Act of 1981, which was welcomed by the City of Philadelphia. At a time when historical federal funding sources are either non-existent or vastly reduced, and when the city's debt capacity for such projects is exhausted, the city is now planning several essential projects necessary to its well-being, which would utilize leases between the city and private sector participants. If incentives such as the Accelerated Cost Recovery System ("ACRS"), rehabilitation tax credits, and Investment Tax Credits ("ITC") were taken away in these vital areas of public service, Philadelphia could not compete successfully for the investment dollar.

While your Committee may correctly view some of the transactions that have received so much national publicity as having little "social value" or justification, at least when compared to their cost to the U.S. Treasury, I urge you to be extremely careful not to use a meat cleaver where the application of a surgeon's knife and skill may best achieve the desired result. To paraphrase an old adage of Justice Holmes, "bad examples make bad laws".

It would be disastrously short-sighted to focus only on tax revenues lost in the short-term while losing sight of the need to rebuild our nation's economy and the substantial long-term employment, tax revenue, and general economic growth which flows from projects such as the ones I will now describe. They represent projects Philadelphia is currently planning to finance using private sector investment combined with leases to the city. They illustrate the versatility of this approach and its usefulness in helping municipalities undertake costly development efforts with sound public benefits.

The city is currently under court order to expand its prison capacity by more than 1,000 beds. To satisfy this order, the city is planning three facilities utilizing private sector investment and leases to the city. The first is a 250-bed modular prison cell project, estimated to cost $10 to $12 million. Bid documents should be ready by late summer. The second is a 400-bed conventionally constructed facility, costing approximately $25 million, on which construction will commence in late 1984. Finally, the city has initiated site acquisition for a 540-bed Center City detention facility, costing approximately $40 million. Public financing is simply not available due to our legal debt limit; yet the city's potential legal liability, as well as the human cost of overcrowded and unsafe prisons, is incalculable if these facilities are not constructed.

Another essential project that could be adversely affected by S. 1564 is the city's planned solid waste disposal facility. Environmental concerns, limited availability of landfill sites, and rising landfill costs, caused the city to seek a long-term solution: the construction of a mass-burn facility which will incinerate over half the trash collected by the city and thereby produce steam and electricity. Because of the enormous financing requirements of such a facility, estimated at about $250 million, and the complexity and financial risk of operating it, we chose to seek a private entrepreneur to perform these functions. This decision is not unlike numerous decisions by municipalities over the years with respect to the provision of other required services or utilities, such as electricity and water. The choice of private enterprise over municipal ownership for such activities is common and certainly not a new idea based on tax considerations.

On March 25 of this year, a Request for Qualifications was issued to vendors and discussions are now underway with the respondents. The city will enter into a long-term service contract with the selected private owner and operator in which it will guarantee delivery of a set number of tons of garbage per year and will agree to pay a negotiated tipping fee to the owner/operator for the service of incinerating and disposing of the city's waste. As in any other private business, the vendor is taking substantial risks if he fails to perform his contractual responsibilities. His profit or loss will depend upon his performance and he will pay taxes on the income he earns. There is no rationale to deny him the tax benefits of normal depreciation that would otherwise accrue to him, just because he is in a contractual relationship with the city. There is certainly no tax benefit that accrues to him just because the city is involved. The fact that the city shares some of this benefit in the same way that a for-profit entity might, should also not be a basis for denying the tax benefits. A change in tax treatment would discriminate against such vendors and add to the city's costs, thereby discouraging construction of such a facility to the detriment of sound social and environmental policies which have been recognized and acknowledged by Congress when it excluded solid waste facilities from the ACRS depreciation restrictions imposed by the Tax Equity and Fiscal Responsibility Act of 1982.

Another planned city project which is viewed as a major business generator for the city's economy, but which would be adversely affected by S. 1564 is our planned new convention center. We are the nation's fifth largest city but rank only twenty-second in the country in terms of our convention business. Our natural advantages of location and ambience to private investors. To the contrary, each involves substantial risk for the private sector participants. Nor is the circumstance of cities choosing private enterprise over municipal ownership for vital public services or utilities a new phenomenon based on tax considerations first enacted in ERTA in 1981. Rather, the financing techniques are options which the city must pursue in order to raise necessary capital for sorely needed projects. The advantages of ITC or ACRS only serve to enable us to compete for funds in the open market. The city's objections to S. 1564 are founded solely on the facts of life faced in capital markets when we compete for a limited supply of dollars and are constrained by rising interest rates, legal debt limits, and decreased federal funding. We seek only the ability to compete effectively for our capital needs.

V. Conclusion.

Thank you for this opportunity to present the City of Philadelphia's views on S. 1564. We urge the Finance Committee to reject any legislation that will unduly restrict the ability of local governments to join with willing private investors to produce new projects with enormous economic and service benefits for their citizens.

MEMORANDUM OF FLEXI-VAN CORPORATION

IN OPPOSITION TO SENATE BILL 1564,
GOVERNMENTAL LEASE FINANCE REFORM ACT OF 1983

PRESENTED TO SENATE FINANCE COMMITTEE
AUGUST 2, 1983

Summary of the Position Paper of Flexi-Van Corporation (Flexi-Van) in opposition to S.1564 and suggested modification to be made thereto.

I. Flexi-Van opposes S1564 in its present form because it will have an adverse economic effect on the container leasing industry. Approximately one-third of the containers available for lease are owned by United States companies and the majority of these containers are leased to non-United States persons. Accordingly, S1564 has a direct impact on such companies and will, if enacted, not allow them to continue to be competitive with foreign companies.

II. Flexi-Van proposes S1564 be modified as follows:

A. Delete the reference to any person who "is not a United States person" in proposed Section 168(B)(E)(iii)(I) and proposed Section 48(A)(5)(B)(i); or

B. Draft a specific exemption from S1564 pertaining to the eleven (11) items of international trade and telecommunications listed in Section 48(A) (2) (B) of the Internal Revenue Code of 1954, as amended, thereby allowing owner lessors of such listed property to be able to continue to claim ITC and ACRS regardless of whom the property is leased to.

III. If S1564 is not modified as suggested in II (A) or (B) above the effect will be to force the expatriation of United States companies as there will no longer be any economic incentive to remain in the United States.

IV. S1564 is in clear conflict with the provisions of United States double taxation treaty policy. Leasing to a non-United States person covered by a double taxation treaty, supposedly a "favored" nation, will result in a loss of ITC and ACRS benefits.

V. Accordingly, Flexi-Van recommends that the Senate Finance Committee re-draft S1564 as suggested herein.

Flexi-Van Corporation (hereafter "Flexi-Van") submits this memorandum in opposition to S1564 entitled "Governmental Lease Financing Reform Act of 1983" (hereafter referred to S1564) and to suggest certain modifications to be made thereto.

Flexi-Van is engaged primarily in worldwide leasing of marine cargo containers and chassis as well as trailers to the transportation industry. Flex-Van believes it is the largest lessor of chassis and the second largest lessor of marine cargo containers in the world and together with other American container leasing companies own 1.2 of the world's 4.2 million twenty foot equivalent units ("TEU") of containers, which are available for lease. Flexi-Van also believes it is the second largest lessor of trailers in North America.

Flexi-Van leases its equipment for periods ranging from several days to several years. All lessee charges are payable in United States Dollars, thereby helping the balance of payments to the United States.

As a result of the relatively short duration of our leases, which is true of the industry in general, and due to the fact that the majority of steamship companies to whom container leasing companies lease are not United States persons, S1564 will have a drastic impact on American container leasing companies.

Impact of the proposed legislation on Flexi-Van and on leasing companies doing business with non-United States persons

If passed, S1564 would deny the use of the accelerated cost recovery system (ACRS) to container leasing companies, and to leasing companies in general, if they lease to person who is not a United States person and the term of the lease exceeds 75% of the class life of the leased property. In the case of a container, the class life is six (6) years, thereby limiting the lease term, if ACRS is to be claimed, to 4.5 years. S1564 will also deny investment tax credit (ITC) to the owner-lessor if the lease is to a person who is not a United States person unless the lease term is less than 30% of the class life of the property. In the case of a container, the lease term would be limited to 1.8 years or the owner-lessor cannot claim ITC.

In short, S1564, if enacted, will place constraints on leasing companies, the effect of which will make them non-competitive with foreign leasing companies.

It is ironic to note that ITC was originally placed in the Internal Revenue Code in order to encourage the infusion of capital into American companies in order to make them competitive with foreign companies, as well as to build American industry. Specifically, the legislative history of ITC leads one to the conclusion that Congress had capital intensive companies in mind when enacting the law permitting ITC and it is clearly the case that a leasing company is a capital intensive company. The loss of ITC together with ACRS will, therefore, have an adverse economic impact on United States leasing companies and especially the container leasing industry. If ITC will be denied in the purchase price of the very item with which a company conducts its business the economic impact is obvious. Moreover, if the company will also be denied ACRS on such property, then the question must be asked as to whether such companies will be able to remain in business.

Recommended Modification to S1564

In view of the adverse impact proposed S1564 will have, Flexi-Van proposes the following modification thereto.

First, Flexi-Van recommends S1564 be modified by the deletion of the reference to any person who "(I) is not a United States person, or" (proposed Section 168(f) (13) (E) (iii) (I)), as well as the deletion of the reference to a person who " (i) is not a United States person, or" (proposed Section 48(a) (5) (B) (i)). Such a modification would continue to permit United States companies to lease to non-United States citizens and obtain the benefits of ACRS and ITC while denying the right to lease to other "tax exempt" entities, as defined in S1564, and continue to obtain the benefit of ACRS and ITC.

Secondly, we recommend that if the definition of "Tax Exempt Entity" will remain as drafted, then an exception should be drafted which specifically exempts from the provision of this legislation the eleven (11) items of international trade and telecommunications specified in Section 48(A) (2) (B) of Internal Revenue Code of 1954, as amended, thereby allowing the owners of such property to continue to obtain the benefits of ACRS and ITC notwithstanding to whom the property is leased.

Flexi-Van respectfully submits that the eleven (11) cases set forth in Section 48(a) (2) (B) dealing with international transportation and telecommunication items for which ITC can be claimed were carefully considered items by the legislature that adopted the same. For this Congress to pass legislation without further study and consideration as to what the effect will be on United States trade, on the balance of payments, the loss of jobs and shrinkage of the market-place is irresponsible.

If the proposed legislation is passed without any of the modifications suggested herein, one result will be to force the expatriation of United States companies. Companies, such as ours, will be forced to consider whether it is economically feasible, or desirable, to continue to be a United States corporation or whether to move the corporation off-shore. Clearly, this is not a desirable result to the United States. Such a move would affect the balance of payments to the United States and would result in the loss of jobs to United States citizens, together with an eventual loss of tax revenues to the United States government.

The proposed legislation also raise serious issues with respect to its effect on United States double taxation policy and would tend to destroy the effect of such policy. For example, under the Treasury Department's Model Double Taxation Treaty and under double taxation treaties negotiated with a number of principal trading partners, the United States has granted exemption from taxation to foreign ship lines in exchange for the reciprocal concession on the part of the foreign country of exemption from taxation of United States ship lines (the Treasury Department Model Treaty also includes reciprocal treatment for container leasing companies).

If the provisions of S1564 are applicable to leases of containers to foreign ship lines which are exempt from United States taxes by treaty and is also applicable to leases to ship lines of non-treaty countries 20% of whose income is not subject to United States taxation, a number of problems result. First, leasing to a ship line from a country covered by a double taxation treaty, supposedly a "favored" nation, will result in loss of ITC and ACRS benefits, except as provided in S1564.

Second, even if the first lease of the containers is to a ship line who pays tax on 21% of its income to the United States or to a United States company, the prospect of subsequent leases to ship lines from treaty countries to ship lines or 20% of whose income is not subject to United States taxation would raise the issue of whether the ITC and ACRS benefits would have to be foregone in most or all leases anyway. There would almost certainly be a lease to a ship line from a treaty nation or a non-United States tax paying ship line at some point in the container's life. Moreover, a decision whether to take the ITC must be made in the first year's tax return, which will occur before the nationality of all lessees in the container's subsequent lease history will become known.

During the hearings on a similar piece of legislation introduced by Congressman Pickle, H.R.3110, the Treasury Department, in its testimony, noted a similar problem with regard to the Pickle legislation and recommended that the provision therein relating to "any person who is not a United States person" be dropped from the proposed legislation pending further study of the same. Flexi-Van recommends that the Senate Finance Committee also delete the reference to any person who is "not a United States person" pending a more comprehensive review of the impact of the proposed legislation and the effect the same will have on the American economy.

S1564, as drafted, is intended to stop certain abuses from continuing to take place. However, by attempting to amend the provisions of the Internal Revenue Code which are being abused, S1564 goes too far and impacts on numerous American industries in a fashion clearly not contemplated at the time of the drafting of the legislation. Accordingly, Flexi-Van strongly urges the Senate Finance Committee to adopt either modification set forth herein pending a comprehensive and systematic study of the economic impact of S1564 prior to enacting the same in its present form in order to ascertain what the consequences would be.

STATEMENT TO THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

ON

THE IMPACT OF S.1564 ON LOCAL GOVERNMENT SOLID WASTE MANAGEMENT/WASTE-TO-ENERGY PROJECTS

July 19, 1983
Submitted for the Record

STATEMENT TO THE COMMITTEE ON FINANCE - U.S. SENATE

BY THE

GOVERNMENTAL REFUSE COLLECTION & DISPOSAL ASSOCIATION (GRCDA)

ON

THE IMPACT OF S.1564 ON LOCAL GOVERNMENT SOLID WASTE MANAGEMENT/WASTE-TO-ENERGY PROJECTS

The individuals and companies who are members of the Governmental Refuse Collection & Disposal Association (GRCDA) are vitally concerned over the possibility that the tax incentives currently available to waste-to-energy projects may be eliminated. These incentives may represent the only economic advantage to encourage local government to move from the practice of land disposal to resource recovery. Without these incentives, many communities may face a continuation of land disposal in the face of ever increasing stringent regulations against disposal practices.

Loss of the ability to finance resource recovery facilities with tax-exempt industrial development bonds will seriously affect the economics and financial stability of such projects. Specifically, this loss could result in the following:

1. Significantly higher tipping fees to municipal residents in order to cover the debt service on an increased principal amount of tax-exempt debt issued to finance such projects. This larger principal amount of tax-exempt debt would be the result of an inability to induce a vendor to contribute equity in order to acquire ownership of the facility in exchange for the available tax benefits.

2. Potentially higher interest rates on tax-exempt debt issued by the municipality, primarily as a result of a greater assumption by the municipality--rather than the vendor--of risks of project construction and operation.

The loss of tax-exempt industrial development bonds for financing resource recovery projects would be particularly punitive in the current economic environment where prices for conventional fuels are significantly decreasing and the value of energy produced by these facilities is falling commensurately. Where there is no corporate entity involved, as the energy sale component of project revenues decreases the financial burden on the residents of the municipalities increases commensurately.

Operating costs of resource recovery systems may also increase significantly when vendors withdraw from the industry. In view of the complexity and technical difficulty involved in successfully operating a resource recovery system, it is not unreasonable to anticipate that loss of vendor expertise will be paid for directly by municipalities.

Overall, it is our view that the utilization of tax-exempt industrial development bond financing for resource recovery projects provides substantially more benefits in the form of reduced tipping fees than any projected revenue loss to the Treasury. This is particularly true when one considers that if vendor financing with tax-exempt industrial development bonds is prohibited, the total financing obligation of the projects will fall on municipalities. Since such municipalities will borrow necessary funds on a tax-exempt basis, little or no revenue gain for the Treasury will result. In fact, since taxable financing of resource recovery projects is not viable for economic reasons, there could be even a larger revenue loss to the Treasury than if industrial development bond financing were allowed to continue.

In order to help you in your deliberations, GRCDA polled many of its members who are actively involved in the planning and implementation of waste-to-energy projects. Over 50 communities responded to our inquiries.

1. Are you still actively pursuing resource recovery?
2. What amount of municipal solid waste will be directed from disposal to resource recovery?
3. What will be the costs of the project?
4. What will the energy savings be?
5. What new jobs will be represented?
6. Are the tax incentives available essential to your project?

Those that responded, all answered in the affirmative regarding the importance of tax incentives. The value of the projects to local government and the economics of the Nation and local government are clearly demonstrated by the response to the questions. If these communities are able to proceed, 35,520 tons per day of solid waste would be diverted from landfills; well over 3.5 billion dollars would be spent for the planning and continuation of these resource recovery projects; the Nation would save over 26,000 barrels of oil per day; 7,600 new construction jobs would be created; and 1,700 new permanent jobs in the public and private sectors would be created! (List of responding communities attached.)

The positive results described above will not be possible if S.1564 were enacted in its current proposed form. We strongly urge that resource recovery/waste-to-energy facilities be given special consideration because of the many positive energy, environmental and economic benefits of waste-to-energy.

We believe that the elimination of existing tax incentives would be a severe setback for local government attempting to make environmentally desirable choices about solid waste management, and in effect would be a de facto mandate by Congress for long term reliance on landfills, an exact reversal of the present policy of the Congress.

GOVERNMENTAL REFUSE COLLECTION & DISPOSAL ASSOCIATION (GRCDA)

LOCAL GOVERNMENT WASTE-TO-ENERGY PROJECT SURVEY

LIST OF RESPONDING COMMUNITIES

Opelika, Alabama

Alameda, California
Long Beach, California
Monterey Park, California
Richmond, California
San Diego, California
San Franscisco, California
Santa Rosa, California

Adams County, Colorado

Windsor, Connecticut

Dover, Delaware (DE Solid Waste Auth.)

Daytona Beach, Florida
Hillsborough County, Florida
Miami, Floria (Dade County)
Palm Beach, Florida
Tampa, Florida

Honolulu, Hawaii

Chicago, Illinois

Brunswick, Maine

Stillwater, Minnesota

Clairemont, New Hampshire (NH/VT Solid Waste Project)

Camden, New Jersey
Essex County, New Jersey
Middlesex County. New Jersey
Newark, New Jersey
Port Authority of New York/New Jersey

Babylon, New York
Binghamton, New York
Glen Cove, New York
New York City, New York
Poughkeepsie, New York

Tulsa, Oklahoma

Providence, Rhode Island

Nashville, Tennessee

Rutland, Vermont

Petersburg, Virginia

St. Thomas, Virgin Islands

Mt. Vernon, Washington
Tacoma, Washington

Altoona, Wisconsin
Waukesha, Wisconsin

SENATE FINANCE COMMITTEE
Hearings on S. 1564

Statement of Cyrus E. Webb,
Senior Vice President of Ingram Corporation
To the Senate Finance Committee

I am Cyrus E. Webb, Senior Vice President of Ingram Corporation, a Delaware corporation headquartered in New Orleans. Ingram Corporation ("Ingram") is engaged primarily in various aspects of the petroleum business and, in particular, the shipping of petroleum and its products in ocean-going tankers. I thank you for the opportunity to submit for the record this prepared statement concerning the effect of S. 1564 on Ingram.

As the Committee knows much better than I, one of the major catalysts for S. 1564 is the TAKX program of the Navy under which the Navy satisfied a requirement for sealift support by chartering ships on a long-term, financing basis. Ingram has under time charter for twenty-five years two ocean-going tankers, the second of which was placed in service by the owner on June 30, 1983. These tankers may from time to time be sub-time chartered to the Navy. Unlike the TAKX program, Ingram contemplates only conventional time charters to the Navy in the normal course of its chartering business. Such charters would have none of the characteristics of the financing charter that permeated the TAKX transaction. The reason for this statement is to seek confirmation in the report of this Committee that such time charters to the Navy will continue to be treated as "service contracts", as they are under present law governing the availability of the investment credit,[1] and therefore will not result in the loss of the credit or reduction of ACRS benefits to the owner of the ships.[2]

Ingram's time charter is an integral part of a two tanker lease financing which various parties committed to in December, 1981 and pursuant to which substantial funds have already been committed. Both tankers are owned by a trust acting for an investor and are bareboat chartered to Tanker Management Inc., an American operator, which time chartered them to a subsidiary of Ingram. Ingram has guaranted the obligations of its subsidiary. The transaction was structured to meet the guidelines of Rev. Proc. 75-21 and Rev. Proc. 75-28. The tanker was built in the U.S. and is owned by a U.S. citizen and is therefore eligible to engage in the United States coastwise trade.. In addition to the two tankers, Ingram has two coastwise eligible tug/barge tanker units under time charter under lease/financing arrangements with the same parties.

Under both the bareboat charter between the owner and Tanker Management and the time charter between Tanker Management and Ingram, Tanker Management, the bareboat charterer, has "exclusive possession and control of the Vessel and shall man, victual, equip, supply, furnish, outfit, maintain and repair, navigate and operate the Vessel. . . . The Master, officers and crew of the Vessel shall be engaged and employed by [Tanker Management] and shall remain [Tanker Management's] servants, navigating and working the Vessel on behalf of [Tanker Management]." (Article III of both the bareboat and the time charters.) Tanker Management also must "provide and maintain insurance" as required. The time charter gives Ingram no operational control or obligation, only the authority to designate the trades in which the vessel is engaged (i.e., where the ship sails) and the cargoes that it carries as in other conventional time charters. Subcharters are permitted, with certain conditions, but Ingram always remains liable to perform its obligations under the time charter (i.e, to pay charter hire). Time charter hire has two components, basic charter hire which covers capital costs and remains constant and operating hire, which covers actual operating costs, and varies. There is no reduction in hire on account of the unavailability of the tanker to Ingram for any reason.

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[1] See LTR 8217040, January 27, 1982, in which the IRS ruled that investment credit remained available when a vessel is time chartered to the MSC on standard terms.

[2] Under S. 1564, only the second tanker would be affected since the first tanker was placed in service on May 21, 1982. Accordingly, this statement will speak only of the second tanker although its arguments and reasoning are equally applicable to both tankers.

Ingram does not carry its own cargoes but rather engages the tankers in the carriage of cargoes for others. This is performed under voyage or sub-time charters in which Ingram assigns its rights to designate the trades and cargoes to the sub-charterer. It is possible that from time to time the Military Sealift Command of the Navy ("MSC") will subcharter one of the tankers and possible that such a charter would be for a term exceeding the 3 year maximum term for the short-term lease exemption provided by proposed new paragraph (13)(C) of Section 168(f). Ingram would expect that these subcharters would be under the standard form MSC time charter (copy attached) with only minor variations. Under MSC practice, such charters do not exceed an initial five year term. Successive one year options, up to five years in total, sometimes are provided but there is no penalty on the MSC for failure to exercise such options.

Ingram seeks confirmation in this Committee's report on S. 1564 that such sub-time charters to the MSC shall be treated as "service contracts" within the meaning of proposed subparagraph (13)(F) of Section 168(f) on the grounds that all of the relevant factors identified therein are satisfied. With respect to the factors set forth in (F) as determinative whether a contract is a service contract, it is clear that a sub-time charter from Ingram to the MSC would satisfy each factor. Specifically, with respect to each:[3/]

(1) (Proposed 168(f)(13)(F)(i)). The MSC will have no control or physical possession of the tanker; in fact, the bareboat charterer has control and possession of the tanker and Ingram, as time charterer, never will have any control or possession to assign to a sub-time charterer; unlike the TAKX transaction which has caused concern, Ingram will bear the full economic risk to make payments of charter hire under its long-term time charter whereas the MSC's obligation to pay for the use of the vessel is subject to various conditions, including that the vessel be in full working order. (Article 11 of MSC standard charter.) Moreover, unlike the TAKX transaction, (i) the MSC will have no ability to replace either the bareboat charterer or Ingram, (ii) there will be no option to purchase the vessel included in the sub-time charter to MSC, and (iii) the MSC will have no right to make any alterations in the vessel. In addition, in the TAKX transaction, (1) the Navy had the right, through option arrangements, to extend the charter period for a total of 25 years with substantial penalties if it failed to exercise options for the full

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[3/] Under a time charter, such as the standard MSC form, the charterer has no control or possession of the ship. It is really a "contract for the carriage of goods designated by [the time charterer] in the ship of [the owner or bareboat charterer]." A demise or bareboat charter, on the other hand, "shifts the possession and control of the vessel from one person to another. . . ." The test "is one of 'control': if the owner retains control over the vessel, merely carrying the goods furnished or designated by the charter, the charter is not a demise" Black & Gilmore, The Law of Admiralty 2d Ed. 1975, pp. 239-40. Thus, the very fact that the MSC charter is a standard type time charter goes a long way toward establishing that it is a "service contract" within the meaning of subparagraph (F).

25 year period (the useful life of the TAKX ships being only 30 years) whereas the term of the standard MSC charter has historically been no more than five years (maximum of ten years with full exercise of options) and the useful life of the tanker is more than 35 years as established by an appraisal made on the date it was placed in service; (2) the Navy was obligated to make capital hire payments irrespective of the availability of the TAKX ships, whereas no obligation to pay any hire exists under the MSC charters when the tanker is unavailable; (3) the Navy had the right to purchase the TAKX ships at a price determined under a formula whereas the MSC will have no option to purchase the tanker at all; and (4) the Navy made a tax indemnity to the owner and operator of the TAKX ships for loss of federal income tax benefits, whereas no such indemnity will exist under the MSC charters.[4]

(2) (Proposed 168(f)(13)(F)(ii)). The parties other than the MSC (the owner, Tanker Management and Ingram) will have a significant possessory or economic interest in the tanker whereas the MSC will have none; Ingram is obligated to pay charter hire consisting of two elements: (1) a fixed element representing a return of capital and (2) a variable element representing the costs of operating the vessel; the MSC will pay a charter hire to Ingram at a rate per deadweight ton to be determined at the time of chartering based on market conditions prevailing at that time; Ingram's obligations under its long time charter are already established and, in effect, it has the economic risk of the vessel's ability to compete in the market for the full term of the charter; the hire payable by the MSC might be higher or lower than Ingram's charter hire for the comparable period but this would depend on the market at that time.

(3) (Proposed 168(f)(13)(iii)(I)). Ingram bears substantial risk of loss from non-performance because of the off-hire provisions in the MSC charter; Ingram may receive no revenues under its subcharter when the tanker is not operable whereas it will always remain liable to pay hire under the long-term time charter;

(4) (Proposed Section 168(f)(13)(F)(iii)(II)). Unlike the TAKX vessels, Ingram concurrently uses the property to provide services to taxable entities. This is not a program wherein a financial transaction was structured to provide

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4/ See description of economic factors in the TAKX program in "Tax Aspects of Federal Leasing Arrangements," prepared by the staff of the Joint Committee on Taxation, pp. 4-8, dated February 25, 1983 for a discussion of these factors in the TAKX program.

> ships to the Navy on a long-term basis. Ingram has time chartered the tanker for twenty-five years without any assurance of a subcharter of even one days' duration to the MSC. In fact, although the MSC is an important factor in the domestic tanker market, Ingram, which has owned or chartered two tug/barge tanker units since 1972 and the sister ship of the tanker since 1982, has only chartered to the MSC on three occasions for periods which aggregated no more than 10 weeks in all that time.* The tanker here at issue is already in service and has now a commercial charter to a non-governmental taxable entity. Any time charter to govermental entities is prospective only and would be only one element of the existing market for domestic trade eligible tankers, although a potentially important one from which exclusion would be extremely harmful.

Thus, an analysis of proposed subparagraph (F) makes it clear that a time charter by Ingram to the MSC under the standard terms would be a "service contract" under all of the relevant factors. Moreover, it would be extremely unfair to adopt legislation which significantly limited the market that existed at the time substantial moneys were committed and expended to build this tanker. It was contracted for at full cost, without subsidy, based on the existence of a coastwise trade of which charters to MSC on standard terms were an important element. In particular -- and of fundamental overriding importance apart from any consideration of the technical application of the standards of S.1564, or any similar bill -- the owner, the bareboat charterer and Ingram did not make their complex and intricate lease/financing arrangements as part of any plan to make the tanker available to the Navy. The financing arrangements depend on Ingram's substantial long-term financial commitment under the time charter, not on any speculative future commitment of the Navy. Ingram merely seeks specific recognition that its normal sub-chartering to the MSC, no different in substance from charters which have been or may hereafter be made with commercial shippers of petroleum and its products, will not result in the imposition of a massive inadvertent penalty which did not exist when the financial commitment to build the tanker was made.

Finally, the effect of imposing a tax penalty in this situation would not earn a single penny for the Treasury. The MSC enters the charter market just like any shipper seeking the cheapest suitable ship. If chartering the tanker here at issue to the MSC would cause a tax penalty to the owner, this will result in the penalty being included in Ingram's quoted rate to the MSC.[5] Since tankers are basically fungible, the MSC would end up chartering an older tanker, fully depreciated for tax purposes with fully vested investment credit, where no tax penalty was involved and therefore not included in the rate. The net effect is that the MSC would be restricted to older tankers and the new tankers limited to the commercial markets. There would be no additional revenues to the Treasury.

Respectively Submitted

By:

Cyrus E. Webb
Senior Vice President
Ingram Corporation

5/ Ingram has indemnified the owner against any loss of ACRS and the investment credit resulting from the enactment of S. 1564.

STATEMENT OF
LEASE INVESTMENT CORPORATION
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
ON
S. 1564
"THE GOVERNMENTAL LEASE FINANCING REFORM ACT OF 1983"

BY
MARTIN E. ZIMMERMAN
PRESIDENT
LEASE INVESTMENT CORPORATION
JULY 19, 1983

Thank you for the opportunity of submitting testimony on certain aspects of S. 1564. I am particularly concerned with the provisions which would, in effect, deny the benefits of leasing to not-for-profit hospitals while preserving the same advantages to for-profit institutions. My purpose is to present facts which shall demonstrate that leasing to not-for-profit hospitals has not been subject to the excesses which may be attributable to leasing to tax-exempt organizations generally, and also to demonstrate that there are good and logical reasons for exempting hospitals from the provisions of S. 1564.

Hospital equipment leasing has been in existence for over fifteen years, and its primary purpose has been to transfer the risks of equipment obsolescence from the hospital lessors to the leasing companies and their residual markets.

My company, Lease Investment Corporation, has been in business for eight years and is one of the leaders in this specialized field. In addition, I am associated with the Association of Equipment Lessors (AAEL) as the Midwest Director of their Tax Committee. Our company acts in the capacity of a "lease investment banker." We recommend to our hospital clients whichever type of financing proves to be the least expensive, whether it is a leveraged lease, taxable installment loan, or tax-exempt debt: we underwrite taxable financing, and a significant part of the time retain whatever tax benefits may exist for our own tax purposes.

Our company also buys and sells used hospital equipment, particularly high technology radiology equipment such as CT scanners, ultrasound equipment, and nuclear cameras for the diagnosis of cancer. Such used and off-lease equipment is typically sold to small community hospitals, physicians' groups in lightly populated areas, or abroad to Latin America and elsewhere. This equipment recycling function is practiced by many of the lessors specializing in hospital equipment.

The procedure followed in a hospital equipment lease is relatively predictable. The hospital chooses the equipment. If leasing is determined to be the least costly alternative over the usual five to seven-year useful life of the asset in the hospital environment, bids are requested and a contract is entered into. The lessor may be the equipment manufacturer, a bank or an independent lessor.

In virtually every case the equipment is paid for by the lessor, and the debt, if any, which is associated with the financing is taxable debt. This is a significant departure from leasing that is done with other tax-exempt entities. Hospital authority bond indentures forbid the sale of assets financed with tax-exempt debt.

Here are a few facts relative to equipment leasing to not-for-profit hospitals:

- Hospital equipment leasing has been in existence since the late 1960's. It has grown at a rate about consistent with the sales of equipment to the industry (i.e., 8% to 12% per year).

- The major incentive of hospital leasing is the ability to transfer the risk of equipment obsolescence from the hospital at a cost which is generally comparable to tax-exempt financing.

- Current market size (other than leasing by manufacturers of their own equipment) is about $300 million per year. This has increased at a modest rather than accelerated rate due to competition from tax-exempt bond and tax-exempt equipment note financing. The amount of revenue which would be raised by applying S. 1564 to hospitals[1] would not be large compared to the resultant loss of capital-raising capability by certain not-for-profit hospitals.

- Virtually all hospital equipment leasing is financed with taxable loans. Sale/leasebacks using tax-exempt debt are virtually nonexistent, due to the restrictive bond indentures common to tax-exempt financing in the healthcare field.

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[1] Estimated to be $10 million the first year and $22-25 million the second through fifth years if leasing to not-for-profit hospitals continued at the same volume. If lessees instead turned to tax-exempt bond financing for the acquisition of equipment through one of the existing programs, the net revenue gain to the Treasury would be zero. If some of the financing were done instead by physicians' groups or for-profit subsidiaries of hospital holding companies, the net tax to the Treasury could be negative, due to the additional deductions resulting from use of the Investment Tax Credit.

- A considerable number of not-for-profit private hospitals which are categorized as "tax-exempt" under the Internal Revenue Code do not or cannot economically borrow on a tax-exempt basis because of restrictions in their state hospital bond authorities or because they are not sufficiently credit-worthy.

- Most hospital leases are for high-technology equipment and leases are usually of five-year duration. This is the expected useful life of CT scanners, nuclear diagnostic and ultrasound equipment, which are representative of the items of equipment leased.

- Prior to ACRS depreciation, five-year facts and circumstances depreciation was the most frequent choice. Many types of hospital equipment become obsolete long before the nine-year ADR guideline life is reached.

- A major service provided by most hospital equipment lessors is to re-market used and off-lease, high-technology medical equipment, thus reducing the net cost of use to the original hospital lessees.

- Many not-for-profit hospitals are forming holding companies and for-profit subsidiaries in order to be able to finance equipment on a more equal basis with for-profit (proprietary) hospitals. Passage of the proposed Bill is likely to dramatically accelerate this trend and, at the same time, increase related legal and accounting expenses.

- Generally, the residual value of the leased property is 15% to 20% of the original fair market value of the hospital equipment, well within acceptable guidelines for equipment salvage value.

The proposed Bill in its present form would cause the cessation of most equipment leasing to not-for-profit hospitals. It would increase the cost of use of high-technology equipment, particularly on a five-year or shorter-term basis.

We believe that hospital equipment leasing is a special area which has neither achieved the size nor experienced the excesses observed in leasing to states, municipalities and other not-for-profit areas. Additionally, the equipment is of a much higher technological content and the availability of ACRS or a comparable depreciation policy is essential to the continued ability to transfer the risks of obsolescence to third parties.

It was in view of these reasons that Chairman Dole, in introducing S. 1564, remarked:

> First we need to assess whether the rules in this Bill (S. 1564) are adequate to prevent abuse in the leasing of short-lived property, while preventing unintended disruption of equipment markets. For example, we need to insure that leases of hospital diagnostic equipment are treated properly.[2]

We respectfully request your consideration of deleting not-for-profit hospitals from the provisions of S. 1564, so long as tax-exempt debt is not used in connection with the initial acquisition of the property.

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[2] 129 CONG. REC. S9487-89 (daily ed. June 29, 1983)

STATEMENT
OF
TOM MOODY, MAYOR OF COLUMBUS, OHIO
FOR THE
NATIONAL LEAGUE OF CITIES
JULY 22, 1983

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE, MY NAME IS TOM MOODY. I AM MAYOR OF COLUMBUS, OHIO, AND A PAST PRESIDENT OF THE NATIONAL LEAGUE OF CITIES.

I AM SUBMITTING THIS TESTIMONY ON BEHALF OF THE 15,000 CITIES REPRESENTED DIRECTLY AND THROUGH OUR 49 STATE MUNICIPAL LEAGUES--CITIES RANGING IN SIZE FROM SCOTLAND NECK, NORTH CAROLINA, TO NEW YORK CITY.

THE GROWING USE OF SALE-LEASEBACK FINANCING BY CITIES, STATES, FOREIGN COUNTRIES, THE PENTAGON, AND OTHER TAX-EXEMPT ENTITIES HAS RAISED CONCERNS ABOUT THE APPROPRIATENESS OF SUCH FINANCING AND ITS POTENTIAL IMPACT ON FEDERAL REVENUES. YOUR LEGISLATION, S. 1564, ATTEMPTS TO ADDRESS THESE CONCERNS BY ABRUPTLY RESTRICTING EXISTING TAX BENEFITS TO THE PUBLIC AND NON-PROFIT SECTOR--INCLUDING MANY WHICH CONGRESS AND THE ADMINISTRATION SPECIFICALLY MADE AVAILABLE AS PART OF THE ECONOMIC RECOVERY TAX ACT OF 1981.

THE NATIONAL LEAGUE OF CITIES SHARES SOME OF THE COMMITTEE'S CONCERNS. HOWEVER, WE BELIEVE THAT TO THE EXTENT THAT NEW INVESTMENTS IN PHYSICAL RESOURCES, RATHER THAN MERE TRANSFERS OF OWNERSHIP PROPELLED BY FAVORABLE FINANCING MECHANISMS, RESULT, THE PURPOSES OF THE 1981 TAX LAW ARE BEING

ACHIEVED AND SHOULD BE PERMITTED. WE BELIEVE IT UNFAIR TO CHANGE RETROACTIVELY RULES RELIED UPON IN GOOD FAITH BY CITIES AND OTHER TAX-EXEMPT ENTITIES.

WE ARE ESPECIALLY CONCERNED THAT THE PENDING LEGISLATION WOULD APPEAR TO SET A DUAL STANDARD, DEPRIVING CITIES OF CRITICAL CAPITAL INVESTMENT BY DIVERTING IT TOWARD PURELY PRIVATE USES. IN OUR VIEW, FEDERAL TAX POLICY, AT THE VERY LEAST, SHOULD NOT DISCRIMINATE AGAINST INFRASTRUCTURE CAPITAL INVESTMENT. IF THE SUBSIDIES ENACTED BY CONGRESS--ACCELERATED DEPRECIATION IN EXCESS OF REAL ECONOMIC DEPRECIATION PLUS INVESTMENT TAX CREDITS FOR BUILDING REHABILITATION--ARE INTENDED PRIMARILY TO ENCOURAGE INVESTMENT IN PLANT, EQUIPMENT, AND REHABILITATION, WHY SHOULD IT MATTER WHETHER OR NOT THE ENTITY MAKING THE INVESTMENT IS TAXABLE?

IN FACT, THE COMBINATION OF ACCELERATED DEPRECIATION AND DEDUCTIONS FOR INTEREST CAN REDUCE THE EFFECTIVE TAX RATE BELOW ZERO FOR ASSETS OWNED BY TAXABLE ENTITIES, GIVING SUCH ENTITIES A MAJOR ADVANTAGE IN THE COMPETITION FOR CAPITAL RESOURCES OVER CITIES, UNLESS CITIES HAVE SOME ACCESS TO THESE SAME PROVISIONS. AS CHAIRMAN DOLE ADVISED THE COMMITTEE LAST MONTH, CORPORATIONS ARE EXPECTED TO RECEIVE FAR MORE IN FEDERAL TAX BREAKS THIS FISCAL YEAR THAN THEY WILL PAY IN FEDERAL TAXES. WE FIND IT DIFFICULT TO UNDERSTAND WHY, IN PRINCIPLE, A SUBSIDY DESIGNED TO ENCOURAGE A PARTICULAR TYPE OF ACTIVITY SHOULD NOT BE AVAILABLE TO ANY ENTITY WHICH CAN PERFORM, REGARDLESS OF THE TAX LIABILITY.

In our view, the committee should consider the tax policy implications inherent in this legislation prior to acting. The proposed approach--to simply restrict the use of generous tax subsidies by tax exempt entities only--would have a significant impact on the allocation of resources and the use of very generous federal tax subsidies. If the committee is concerned about fiscal implications from these subsidies, reductions for all users might be the most reasonable means of reducing the incentives for sale-leasebacks and raising some of the revenue needed to respond to the projected long-term deficits.

If, by way of contrast, the committee is concerned about abuses or inappropriate use of tax subsidies, then we believe the legislation should be so focused. NLC is sympathetic to such a concern and would welcome the opportunity to work with the committee in restricting such practices.

Accordingly, NLC recommends that the pending legislation be changed as follows:

1. Current tax provisions for cities leasing equipment or using service contracts should not be changed. Therefore, those provisions should be removed from the bill.

-- In municipalities, hospitals, police and fire departments particularly rely on equipment leases and have traditionally--especially for communications, computer, and medical technology equipment. The reliance on leasing has been based upon the prohibitive acquisition costs and the relatively early obsolescence of such equipment. The equipment, in these cases, is necessary to meet our municipal

RESPONSIBILITY TOWARDS PUBLIC HEALTH AND SAFETY IN LIFE THREATENING SITUATIONS FOR THE POOR, UNEMPLOYED, AND INDIGENT WHO HAVE NO ACCESS TO TAXABLE, FOR-PROFIT MEDICAL INSTITUTIONS.

REMOVAL OF THE TAX INCENTIVES FOR PRIVATE INVESTORS WILL INCREASE THE COST OF THESE PUBLIC SERVICES. IT WILL CREATE AN ANOMOLOUS SITUATION IN WHICH, FOR INSTANCE, A PRIVATELY OPERATED HOSPITAL WITH A WEALTHY TO MIDDLE CLASS CLIENTELE CAN RECEIVE THE BENEFIT OF TAX CREDITS AND ACCELERATED DEPRECIATION ON LEASED MEDICAL EQUIPMENT, WHILE A NON-PROFIT HOSPITAL SERVICING THE NEEDS OF MORE NEEDY CITIZENS MUST PAY A HIGHER PRICE.

SIMILAR COMPARISONS COULD BE DRAWN FOR OTHER EQUIPMENT NEEDS SHARED BY CITIES AND PRIVATE CORPORATIONS. THE IMPLICIT THEORY WOULD APPEAR TO BE THAT CITIES ARE IN A BETTER FISCAL SITUATION THAN THE PRIVATE SECTOR TO PAY FOR SUCH NEEDS.

2. SALE-LEASEBACK ARRANGEMENTS FOR BUILDINGS OR FACILITIES SHOULD BE ALLOWED UNDER CURRENT TAX LAWS, IF THEY ARE FOR NEW CONSTRUCTION OR TO FINANCE SUBSTANTIAL REHABILITATION OF AN EXISTING STRUCTURE OR FACILITY.

HOWEVER, IF INDUSTRIAL DEVELOPMENT BONDS ARE USED TO FINANCE CONSTRUCTION OR REHABILITATION OF OTHER THAN RESOURCE RECOVERY OR WASTEWATER CONSTRUCTION PLANTS, THEN THE DEPRECIATION PERIOD SHOULD BE EXTENDED.

-- DUE TO THE HIGH COST OF BORROWING, STATUTORY DEBT LIMITS, AND THE REDUCTION OF FEDERAL AID, CITIES HAVE NO ALTERNATIVES BUT TO SEEK PRIVATE CAPITAL INVESTMENT. WHILE CONGRESS HAS INCREASINGLY RECOGNIZED THE SIGNIFICANT INFRASTRUCTURE NEEDS OF THE NATION, THE BURDEN OF RESPONDING HAS, SO FAR, BEEN LEFT TO STATES AND LOCAL GOVERNMENTS.

A RECENT REPORT BY STANDARD AND POOR'S CORPORATION STATED THAT STATES AND LOCALITIES MUST FIND ALTERNATIVE FINANCING FOR THEIR WASTEWATER TREATMENT PROJECTS. ACCORDING TO THE REPORT, DECREASES IN FEDERAL AID "MAKE LOCAL SELF-FINANCING IMPERATIVE." THE AUTHORS WARNED THAT FAILURE TO MAKE UP THE FINANCING GAP LEFT BY DECREASED FEDERAL INVOLVEMENT WILL HAVE ADDITIONAL NEGATIVE CONSEQUENCES, INCLUDING "INHIBITING ECONOMIC GROWTH." THEY WROTE THAT "BY FAILING TO MAINTAIN ADEQUATE FACILITIES, THE MUNICIPALITY RISKS A LOSS OF REVENUES TO SUPPORT THE EXISTING SYSTEM, POSSIBLE OVERUSE AND ADDED WEAR ON WASTEWATER STRUCTURES, AND INCREASED OPERATING AND MAINTENANCE AND DEBT SERVICE COSTS."

WE WOULD URGE THE COMMITTEE TO MOVE CAUTIOUSLY ON ANY INITIATIVE TO REDUCE INCENTIVES FOR INVESTMENT IN OUR NATION'S PUBLIC INFRASTRUCTURE. AT A TIME WHEN JAPAN HAS INVESTMENT IN ITS PUBLIC INFRASTRUCTURE AT FIVE TIMES THE LEVEL IN THIS COUNTRY, WE CAN ILL AFFORD TO FALL FURTHER BEHIND.

I AM PARTICULARLY CONSCIOUS THAT MOST CITIES DO NOT HAVE THE OPPORTUNITY, WITH THEIR OWN RESOURCES, TO DEAL EFFECTIVELY, AND IN COMPLIANCE WITH FEDERAL MANDATES, WITH THE MULTIPLE PROBLEMS OF SOLID WASTE DISPOSAL, RESOURCE RECOVERY, AND INFRASTRUCTURE. WE DO NOT BELIEVE, GIVEN CURRENT BUDGET RESTRAINTS, THAT THERE ARE ANYWHERE NEAR SUFFICIENT FEDERAL RESOURCES. WE ARE OF THE VIEW THAT ONLY THROUGH LEVERAGING PRIVATE SECTOR INVESTMENT CAN WE BEGIN TO REBUILD OUR NATION.

As an example of the sorts of problems confronting us at the local level, consider Philadelphia. The City is under a court order to expand its prison capacity by more than 1,000 beds--at a cost of some $77 million. The city's statutory debt limit--for all municipal debt--is $60 million. This limit is imposed by the Constitution of the Commonwealth of Pennsylvania. There is simply no public financing legally available to the city, not to speak of the human cost of overcrowded and unsafe prisons.

We do, however, feel it appropriate for the Committee to restrict sale-leaseback financing where the sole purpose is to take advantage of the tax code. Consequently, we support those provisions in S. 1564 which would restrict sale-leaseback tax benefits for existing buildings or facilities. Further, we recommend that in sale-leaseback transactions between any parties where industrial development bonds are used to finance construction or rehabilitation costs, the depreciation period should be extended. This restriction should not be applied only to tax-exempt lessees.

Our Board of Directors has determined that there should be two exceptions. The Board decided that resource recovery and wastewater treatment plants serve such basic public purposes, involving federally mandated costs, that we should provide the highest incentives for their construction or rehabilitation.

3. Sale-leaseback financing of all other existing buildings or facilities should require investors to use an extended depreciation period.

4. EXISTING EXEMPTIONS INCLUDED IN THE 1981 AND 1982 TAX ACTS SHOULD BE RETAINED: BUILDINGS QUALIFYING FOR REHABILITATION TAX CREDITS, QUALIFIED MASS TRANSIT VEHICLES, AND VOLUNTEER FIRE DEPARTMENTS.

5. EXISTING PROJECTS PARTIALLY COMPLETE SHOULD BE ALLOWED TO BE COMPLETED AND THE RESTRICTIONS OF THE BILL SHOULD ONLY APPLY TO PROJECTS STARTED AFTER THE EFFECTIVE DATE OF ANY BILL PASSED.

-- THE APPREHENSION CREATED BY THE RETROACTIVE DATE IN THE PROPOSED LEGISLATION CREATES GREAT INVESTOR UNCERTAINTY, SHIFTING CAPITAL INVESTMENT AWAY FROM THE PUBLIC SECTOR. THIS SHIFT CONTRADICTS EXISTING LAW AND FEDERAL TAX POLICY WITHOUT FULL HEARINGS OR DELIBERATIONS BY THE CONGRESS. IT UNDERCUTS MONTHS OF INVESTMENT AND PLANNING IN MANY MUNICIPAL PROJECTS WITH NO FINDING OF ABUSE.

IN SUM, NLC SHARES THE INTEREST OF THE CHAIRMAN TO ELIMINATE ABUSES. PRACTICES SUCH AS THOSE USED BY THE U.S. NAVY TO AVOID CONGRESSIONAL BUDGET REVIEW AND USE OF TECHNIQUES TO AVOID ARBITRAGE REGULATIONS SHOULD BE CORRECTED TO ASSURE THAT TAX INCENTIVES ARE DIRECTED TO LEGITIMATE PUBLIC NEEDS. AT THE SAME TIME, WE WOULD URGE THE COMMITTEE TO STRUCTURE AN EQUITABLE REFORM MEASURE THAT TREATS ALL ENTITIES EQUALLY AND FULLY CONSIDERS THE IMPORTANCE OF PRIVATE CAPITAL INVESTMENT IN OUR NATION'S CITIES' INFRASTRUCTURE.

THANK YOU.

NATIONAL HYDROPOWER ASSOCIATION
2010 MASSACHUSETTS AVENUE, N.W., 4TH FLOOR
WASHINGTON, D.C. 20036
(202) 466-5570

July 25, 1983

The Honorable Robert J. Dole, Chairman
Committee on Finance
U.S. Senate
Washington, DC 20510

Dear Chairman Dole:

This letter is submitted for inclusion in the record of the hearings held on July 19, 1983, on S. 1564, the Governmental Lease Financing Reform Act of 1983, on behalf of several trade associations and other organizations which represent members of the renewable energy and cogeneration industries. These organizations include the American Wind Energy Association, the Cogeneration Coalition, the International Cogeneration Society, the National Hydropower Association, the Renewable Energy Institute, the Solar Energy Industries Association, and the Solar Lobby. These organizations strongly endorse the efforts of this committee to curb tax abuses arising out of leasing arrangements between taxable entities and tax-exempt organizations. However, there is one provision in the bill which has already generated considerable concern within the renewable energy and cogeneration industries. That provision concerns the classification of service contracts as leases for purposes of present restrictions on the investment credit and proposed restrictions on the availability of ACRS deductions.

Tax-exempt organizations and governmental organizations are substantial consumers of electrical and thermal energy. As such, they are well suited to take advantage of the energy alternatives presented by renewable energy and cogeneration systems. Potential customers for the output of such systems range from hospitals, which can use the thermal energy produced by cogeneration or solar systems; to municipal electric utilities and rural electric cooperatives which can use the electricity produced by cogenerators, windfarms, and hydroelectric plants.

Currently, property leased to a governmental unit or tax-exempt organization is ineligible for the investment and energy tax credits. Moreover, the IRS has long taken the position that service contracts which more closely resemble leases than actual service contracts in substance should be classified as leases for purposes of this rule. However, both the IRS and the courts have also recognized that property used to provide a service to a governmental unit or a tax-exempt organization under a legitimate service contract should remain eligible for the tax credits. This distinction is based on sound public and tax policy considerations, since there is no reason why legitimate, tax paying service related businesses should be treated differently merely because their customers are tax-exempt, as opposed to taxable, entities.

The IRS has applied a variety of criteria, including control over use of the property, right to possession of the property, and risk of loss with resect to the property, in distinguishing service contracts from leases. Applying these criteria, the IRS has disallowed the investment and energy tax credits for a variety of transactions in which a purported service contract was found to more closely resemble a lease. At the same time, the IRS has allowed the investment and energy tax credits for transactions in which there is a legitimate service contract, in which the service provider bears substantial business risks such as risk of loss with respect to the property and the burden of operating and maintaining the property.

One section of S. 1564 would amend the Internal Revenue Code to specify that a contract which purports to be a service contract, but which more closely resembles a lease, will be treated as a lease for purposes of determining eligibility for the credits. This provision indicates that the determination of whether a lease more closely resembles a service contract is to be based on all of the facts and circumstances, including whether the user has control over the property and whether the user has a significant possessory or economic interest in the property.

This proposal has generated considerable confusion and uncertainty within the renewable energy and cogeneration industries. In particular, we are concerned that, as Mr. Chapoton suggested in his testimony before the Ways and Means Committee on H.R. 3110, a rule might be adopted under which equipment which is used to provide a service to a single tax-exempt or governmental customer might, for that reason alone, be deemed to be leased to that customer. Industry members are also concerned that a rule might be adopted under which equipment which is used to provide a service to a tax-exempt or governmental customer and which is located on the premises of the customer might, for that reason alone, be deemed to be leased to that customer. Either of these rules, if adopted, could have devastating impacts on our industries.

Renewable energy and cogeneration projects generally produce electrical or thermal energy, frequently for sale under a power sale contract to a third party customer. Power sale contracts are usually structured to comply with the existing IRS criteria for classification as service contracts. Thus, the project owners generally bear all of the business related responsibilities and risks with respect to the project, such as the responsibility for operation and maintenance of the project and the risk of commercial or catastrophic loss with respect to the project. Moreover, the terms of these contracts (and the price for the output of the projects) are generally the same regardless of whether the customer is a taxable entity, a tax-exempt organization, or a governmental unit. However, if either of the rules discussed above were adopted, it would be impossible for many of these transactions to qualify as service contracts even if the project owner bears all of the business related responsibilities and risks, solely as a result of the technological and regulatory constraints imposed on these technologies.

Because of engineering and technical considerations, such as the limits on the distance over which thermal energy can be transported, thermal energy projects such as solar thermal and cogeneration projects generally must be designed to serve the needs of, and to be located on the premises of, a single customer. While the product of electrical generating projects such as hydroelectric and wind energy projects is more readily transported, legal and regulatory considerations such as those contained in the Public Utility Regulatory Policies Act of 1978 generally compel non-utility power producers to sell all of their output to a single utility customer. Thus, rules based solely on the number of customers or the location of the equipment could make it inherently impossible for power contracts for the sale of the output of renewable energy or cogeneration projects to tax-exempt or governmental customers to qualify as service contracts for tax purposes.

We urge you and the other members of the Committee not to adopt rules which would differentiate renewable energy and cogeneration projects, not on the basis of the allocation of business responsibilities and risks between the parties, but on the basis of technological factors which are inherent in such projects, and over which the parties have no control. Moreover, because of the uncertainty and concern which has already been generated by the various proposals which have been made in connection with S. 1564, we urge you to specify in the legislative history that no such rule is contemplated. This could be accomplished by including a statement similar to the attached model statement in the legislative history of the bill.

Respectfully submitted,

Lee Good

Lee M. Goodwin
Vice President and
General Counsel

Enclosure

LG/js

MODEL REPORT LANGUAGE FOR H.R.3110 AND S. 1564

Under prior law, a contract for the sale of the output of an electrical or thermal energy producing system owned by a taxable entity would be classified as a service contract rather than a lease even though the system was located on the premises of a tax exempt (or governmental) customer and supplied all of its output to that customer, provided that the system's owner bore the financial burden of building and operating the system and the risk of loss in the event that the system failed to perform. See, for example, LTR 8152097, in which a contract for the sale of thermal energy produced by a solar system was held to be a service contract, rather than a lease,even though the system was located on the premises of a tax exempt entity and supplied all of its output to that entity. See also LTR 8228104, involving a similar arrangement between a solar energy system and a local government. This provision is not intended to alter the treatment of such systems. For example, under this provision, if a hydroelectric facility is built, owned and operated by a taxable entity, and if that entity bears the risk of loss if the facility fails to perform, the contract for the sale of electricity produced by that facility would be classified as a service contract, rather than a lease, even if the facility is built on property owned by a tax exempt or governmental entity (such as a rural electric cooperative) and all of the electricity produced by the facility is sold to that entity.

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July 14, 1983

HAND DELIVERED

Roderick De Arment
Chief Counsel, Senate Finance Committee
SDOB 221
Washington, D.C. 20510

Re: S. 1564

Dear Rod:

On behalf of the National Leased Housing Association and on behalf of the Coalition for Low and Moderate Income Housing, I am writing to you with respect to S. 1564, the "Governmental Lease Financing Reform Act of 1983" and the proposed hearings on this legislation.

I do not believe that it is necessary for my clients to testify with respect to this matter, but I would like to call to your attention two important concerns that they have.

Enclosed is a letter which I wrote on June 28, 1983, to Congressman Pickle with regard to H. R. 3110, in which both of these concerns are discussed fully.

First, we propose that the legislation except residential rental property sold and leased back by a public housing authority or similar governmental agency. The reasons for this are fully stated in my letter to Congressman Pickle.

Secondly, we propose that the legislation make it clear that certain taxable entities, which for other purposes may be considered agencies or instrumentalities of the United States, are not to be considered as such for purposes of this legislation, since they fall outside the intent of the legislation. Again, the reasons for this are fully set forth in my letter to Congressman Pickle.

We would appreciate your attention to these two points, which we believe are in the public interest and which will greatly improve the proposed legislation.

If you have any further questions concerning this matter, please do not hesitate to contact me.

Sincerely yours,

Bruce

Bruce S. Lane

BSL:dsz

Encl. (1)

cc: Hon. Robert Dole
David H. Brockway
Jack Sterling

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* NOT ADMITTED IN D.C.

June 28, 1983

HAND DELIVERED

Honorable J. J. Pickle
Room 242
Cannon House Office Building
Washington, D. C.

Re: H. R. 3110

Dear Congressman Pickle:

On June 8, 1983, my partner Charles L. Edson, testified before the Ways and Means Committee on behalf of the National Leased Housing Association.

I am writing to you today to supplement his testimony, both on behalf of the National Leased Housing Association and on behalf of the Coalition for Low and Moderate Income Housing, which we also represent.

In reviewing H. R. 3110 further, we have encountered two problems with the definitions contained in such legislation and we would like to bring them to your attention prior to the mark-up.

First, we recommend that proposed Subsection 168(f)(13)(C)(ii) be amended to read as follows (underscoring indicates new language):

> "(ii) FIFTEEN-YEAR REAL PROPERTY - In the case of 15-year real property, the term 'tax-exempt use property' means any property (other than residential real property) to the extent used by a tax-exempt entity where - "

Secondly, we recommend that proposed Subsection 168(f)(13)(D)(i) be amended to read as follows (underscoring indicates new language):

"(i) the United States, any State or political subdivision thereof, any possession of the United States, any foreign government, any international organization, or any tax-exempt agency or instrumentality of any of the foregoing."

The first correction proposed above would, in effect, except residential rental property sold and leased back by a public housing authority or similar governmental agency from the effect of H. R. 3110. Substantially all of such housing is low and moderate income housing, and much of it is in a state of considerable deterioration. One of the few ways that public housing authorities and similar agencies can obtain the funds necessary to modernize such housing is to sell it to a limited partnership for purposes of syndication and then to lease it back. Ultimately, the housing reverts entirely to the public authority.

Since public housing authorities cannot levy taxes, since Congress is eliminating or drastically reducing most of the direct subsidies related to housing, and since public housing authorities are not the objects of charity, without the ability to raise funds by this method, much public housing will eventually fall into total disrepair and may have to be eliminated entirely from the nation's housing stock. In view of the dramatic need in this country for housing for low and moderate income individuals, we urge you not to close off this method of modernizing, improving and maintaining such housing.

The second correction proposed above would make it clear that certain taxable entities, which for other purposes may be considered agencies or instrumentalities of the United States, are not to be considered as such for purposes of H. R. 3110, since they fall outside the intent of the legislation. We have in mind, for example, the National Railroad Passenger Corporation (AMTRAK), the Federal National Mortgage Association (FNMA), and similar entities established by Congress, which for some purposes are considered agencies or instrumentalities, but which for most practical purposes are private corporations subject to all federal income taxes. Unless this amendment is made, uncertainty will be created as to whether H. R. 3110 applies to them, and, in the case of AMTRAK, its ability to renovate and rehabilitate structures such as old railroad stations and to restore them to viable commercial uses, may be greatly hampered or impeded.

Thank you for your consideration of these points.

Sincerely yours,

Bruce S. Lane

BSL:clr

cc: Hororable Daniel Rostenkowski
John J. Salmon, Esquire
Robert J. Leonard, Esquire
David H. Brockway, Esquire
Richard Mull, Esquire

National Realty Committee
2033 M STREET, N.W. · WASHINGTON, D.C. 20036 · 202 785-0808

STATEMENT OF THE
NATIONAL REALTY COMMITTEE
ON
S. 1564
GOVERNMENTAL LEASE FINANCING REFORM ACT OF 1983

SUBMITTED TO THE
COMMITTEE ON FINANCE

UNITED STATES SENATE

JULY 19, 1983

I. The National Realty Committee

The National Realty Committee, Inc. is a non-profit business league whose membership includes owners, operators, financiers, and developers of all types of real estate throughout the United States.

The National Realty Committee respectfully submits the following comments with respect to S. 1564.

II. In General

The National Realty Committee supports the general objectives of S. 1564 but is concerned that the scope of the proposed statutory amendments exceeds the area of perceived abuse and unnecessarily impinges upon legitimate business transactions. Chairman Dole in introducing S. 1564 described "leasing horror stories" intended to be prevented by the proposed legislation. In his statement, the Chairman pointed out:

> "What leasing permits these nontaxpayers to do is to trade on their tax-exemption. Such entities are unable to use tax credits and accelerated depreciation - ACRS - which are designed to reduce the cost of capital for taxpayers. A lease permits the nontaxable entities to sell such tax preferences. ...

> "*The impact on Federal receipts of tax-exempt leasing is substantial. That is because such transactions create deductions and rehabilitation credits where they did not exist before. ...*
>
> "[S. 1564] would address these abuses by eliminating the tax credits and accelerated depreciation for property subject to tax-exempt leases. By eliminating the availability of such tax benefits, the tax motivation for such transactions, leasing by tax-exempt[s] will no longer be tax-motivated. The tax law will again be neutral on the decision by tax-exempts to lease or to buy."

The National Realty Committee subscribes to the objectives set forth by Chairman Dole. We are concerned, however, that S. 1564 as drafted can apply to leases made by taxable landlords with tax-exempt lessees which do not involve any sale by any nontaxable entity of any tax preference nor the creation by virtue of such lease of deductions or credits that did not exist prior to the leasing transactions.

The National Realty Committee therefore proposes that S. 1564 be amended to limit its application to those situations in which nontaxable entities do in fact attempt to sell tax preferences or to create deductions and credits where they did not exist before, and to eliminate from the scope of the legislation leases of existing property where the landlord is already entitled to such deductions or credits. Unless a landlord holding an existing building for rent can secure the same tax benefit whether he leases such building to General Motors or to the local branch of the Salvation Army the tax law will not be neutral with respect to either the landlord or the tenant.

We note in this regard that S. 1564 includes certain changes from a similar measure, H.R. 3110, which attempt to distinguish real property leases involving the abuses sought to be remedied from leasing transactions which are intended to be permitted. This is accomplished primarily by limiting application of the statute to real property leases which cover more than 50% of the property and, with certain exceptions, to leases having a term, including any renewal options, in excess of 10 years. We believe these limitations are appropriate but do not go far enough.

III. Specific Proposals

A. Further limitations on the term "tax-exempt use property" under proposed Code Section 168(f)(13)(C)(iv).

We propose that there be excluded from the term "tax-exempt use property" real property used by a tax-exempt entity where (a) the tax-exempt entity neither receives nor will receive any consideration for entering into the lease of such property (other than the right to use such property for the term of the lease upon the payment of the rental therefor), and (b) the real property subject to such lease has been in use for more than two (2) years prior to the execution of such lease.

Amending the proposed legislation to include the foregoing limitations on the term "tax-exempt use property" will nevertheless prevent any tax-exempt entity from selling any tax preference through a sale-leaseback or similar transaction and the limitation on the exclusion to property in use for more than two (2) years will prevent construction or substantial rehabilitation of the property on behalf of a tax-exempt entity. The proposed limitations will, however, permit a taxpayer owning an existing vacant building to lease the building in its entirety to a tax-exempt entity on a lease having a term in excess of ten (10) years without being penalized by reason of the nature of the tenant as a tax-exempt rather than taxable entity. In such a case, while the tax-exempt lessee may be indirectly the beneficiary of a market rent established by rental levels which taxable lessees are prepared to pay and taxable lessors prepared to accept, the primary effect of any change in recovery period or availability of tax credits is imposed upon the lessor not the lessee. We believe that a taxpaying landlord owning an existing building held for rental should have the opportunity to lease space on competitive terms and conditions to any tenant that he can get without reference to the taxpaying status of the tenant.

B. Recovery Period

Where the restrictive rules of S. 1564 apply, proposed Code Section 168 (f)(13)(A)(ii) applies a recovery period equal to the greater of forty (40) years in the case of 15-year real property or a period equal to 125% of the term of the lease. The foregoing rule seems unduly harsh. Limiting the recovery period to the lesser of forty (40) years or a period equal to 125% of the term of the lease would appear to be a more than adequate sanction.

C. Effective Dates

The proposals currently contained in S. 1564 for grandfathering transactions entered into prior to the effective date of the legislation are too limiting.

Particularly where any taxpayer has previously purchased property used in whole or in part by a tax-exempt entity, the new rules should not apply to either such taxpayer or any purchaser of the property from such taxpayer. The new rules should be limited to situations where the first use of the tax-exempt entity occurs after the effective date of such legislation. Otherwise, all existing owners of properties which are currently being used by tax-exempt entities will suffer a reduction in the fair market value of their interests.

Respectfully submitted,

E Wayne Thevenot

E. Wayne Thevenot
President

SPERRY

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GERALD K. HOWARD
Vice President
Tax Planning and Tax Counsel

July 22, 1983

The Honorable Robert Dole
Chairman, Senate Finance Committee
Room 5D-221
Dickson Senate Office Building
Washington, D. C. 20510

Dear Senator Dole:

Sperry Corporation is a diversified high-technology company in the business of developing, manufacturing and selling computer systems and equipment, farm equipment, guidance and control equipment, and fluid power equipment. Sperry's Computer Systems unit leases a substantial amount of computer equipment to tax-exempt organizations, including agencies of Federal and state governments.

The following comments are submitted for your consideration for inclusion in the hearing record for S.1564:

The purpose of S.1564 is to correct abuses that have resulted from (1) the sale by tax-exempt entities of tax credits and ACRS depreciation benefits to taxpayers; and (2) the sale and long-term leaseback of real property (primarily).

Sperry and other members of the computer equipment industry have not received unintended tax or other benefits from leasing equipment to tax-exempt organizations. The bill, in our judgment, should not be applicable to computer equipment and other depreciable assets that are not causing the abuses that the bill is directed at.

Computers have a technologically short life, depreciate in value rapidly after being placed in service, and generally become obsolete within five years. If enacted, S.1564 would be the third change to the depreciation rules in three years that has failed to recognize the economic life of computers.

Under the Asset Depreciation Range System of depreciation, computer equipment has a class life of six years and a depreciation range of five to seven years. Some members of the computer industry, Sperry included, lease equipment in this class to tax-exempt organizations under lease contracts that have a five-, six-, and seven-year term. This equipment would not qualify as "short-lived property" under paragraph (C) (iii) of the bill because the term of the lease to which such property is subject is more than 75 percent of the present class life of such equipment, i.e. five-to-seven-year lease term, rather than four and one-half years or less (75% of six-year class life).

We believe that computer equipment leased to tax-exempt organizations for a term equal to their class life (or less) should qualify as short-lived property, so that all members of the computer industry may receive fair treatment under S.1564.

In summary, we do not believe that the current rules for depreciating computer equipment that is leased to tax-exempt organizations present an opportunity to abuse the tax laws. If it is decided that S.1564 should apply to computers and other high technology short-lived property, the definition of short-lived property should be amended to include computer equipment that is leased for six years or less, so that all members of the computer industry may be treated fairly under S.1564.

Thank you for considering our comments.

Very truly yours,

Gerald K. Howard

Gerald K. Howard
Vice President
Tax Planning and Tax Counsel

GKH:tf

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COUNSEL

July 18, 1983

VIA FEDERAL EXPRESS

Senator Robert J. Dole
Chairman, Senate Finance Committee
221 SDOB
Washington, D. C. 20510

Dear Mr. Chairman:

We would like to take this opportunity to comment on the effective date ("transitional") rules set forth in the Governmental Lease Financing Reform Act of 1983 (S. 1564). We would greatly appreciate inclusion of this letter in the official hearing record.

We represent one of several investors in a complex financial transaction which involves the purchase and lease of a new Boeing 747-312 aircraft delivered on June 30, 1983 to Singapore Airlines Limited. Singapore Airlines Limited's Purchase Agreement for construction of the aircraft was signed on March 1, 1982. Negotiations between our client and Singapore Airlines Limited involving the assignment of the Purchase Agreement to our client (as one of a number of investors) and the lease of the aircraft to Singapore Airlines commenced during August 1982, and the lease and financing documents were entered into on June 30, 1983, culminating 10 months of negotiations.

The transitional rules of both S. 1564 and H. R. 3110, as currently drafted, require binding contracts on May 23, 1983 both to acquire and to use the property. Thus, in our client investor's case the new substantive rules in these bills would apply because only the contract to acquire, but not the lease, was binding on May 23, 1983. In this case, as in most commercial leasing transactions for aircraft, the prospective lessee enters into an enforceable purchase agreement with the manufacturer first and subsequently negotiates with prospective investors the purchase of the aircraft by the investors pursuant to an assignment of the purchase agreement and lease by the investors to the lessee (or a simultaneous purchase, resale, and leaseback). Generally, the lease (i.e., the agreement to use) is not closed, and thus is not enforceable, until on or shortly before the delivery date for the aircraft. For example, in our client investor's transaction, Singapore Airlines Limited entered into its purchase agreement for a Boeing 747-312 aircraft on March 1, 1982 and negotiations with our client, as a prospective member of the lessor group, spanned the 10 month period from August 1982 until the closing of the lease and delivery of the aircraft on June 30, 1983. Since the lease was not binding on May 23, 1983, the transitional rules now contained in S. 1564 would not permit this transaction to remain covered by current law, even though it is the type of transaction that should be grandfathered by virtue of Singapore Airlines Limited's long standing commitment to purchase the aircraft from Boeing.

We recognize some of the abuses that Congress is trying to correct, in particular the allowance of investment tax credits and ACRS deductions with respect to foreign manufactured transportation and certain other equipment used by foreign persons, where the transaction has very little contact with the United States apart from the fact that there is a domestic lessor. However, we question whether this type of financing method, which admittedly is very popular, should be precluded altogether in the case of U.S. manufactured equipment. The allowability of the investment tax credit and full ACRS deductions is already limited to property used "predominantly" in the United States. Although special treatment for U.S. registered vessels and aircraft and certain other types of property is provided by Section 48(a)(2) of the Internal Revenue Code, this treatment reflects a policy decision as to the types of equipment for which an investment incentive was deemed desirable. We believe that, if a further restriction is desirable, it should not affect equipment manufactured in the United States, the sale of which results in taxable income and also benefits the domestic economy.

In summary, we believe that S. 1564 should not restrict the federal income tax benefits now provided in the case of U.S. manufactured leased property. Furthermore, if such property is to be covered under S. 1564, we believe that the transitional rules should be broadened to cover transactions such as this one, because the aim of the transitional rules should be to preserve the expectations as to federal income tax treatment of the parties to those transactions which were sufficiently close to consummation on May 23, 1983 that it would be inequitable to apply the new rules to them.

Very truly yours,

Louis H. Nevins

Transamerica
Interway

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August 1, 1983

STATEMENT OF TRANSAMERICA ICS CONCERNING S. 1564 (GOVERNMENTAL LEASE FINANCING REFORM ACT OF 1983)

Transamerica ICS, a U.S. corporation, with its principal place of business in New York, New York, is one of the largest freight container lessors in the world. It operates a fleet of containers in excess of 200,000 TEU's (twenty foot equivalent units).

Transamerica ICS is a subsidiary of Transamerica Interway Inc., which is in turn a subsidiary of Transamerica Corporation, a publicly traded, diversified corporation headquartered in San Francisco, California.

ICS leases containers on an operating lease basis for short to medium terms (a few days to five years) and provides together with the containers various services including (a) ability of a steamship customer to pick up and drop off containers where and when they are needed, and (b) the assumption by ICS for a fee, of substantially all the damage and maintenance of the containers. In order to provide these services, ICS must maintain a sophisticated communications network and in excess of 200 depots throughout the world for the return, delivery and repair of its containers.

ICS estimates that during the useful economic life of a container, it is leased on average to six or seven different steamship companies some of whom may be U.S. Flag carriers and some of whom may be foreign entities who may or may not be U.S. taxpayers.

ICS, for the following reasons urges the deletion of those provisions of S. 1564 that sweep foreign corporations within the ambit of the bill's primary thrust (domestic governmental leasing).

1. The container leasing business has been traditionally a U.S. based business, in part in recognition of the availability of the Investment Tax Credit (ITC) and accelerated depreciation. Congress in the original ITC legislation, provided expressly for availability of the ITC to containers, even though they are used predominately outside the U.S. provided they are used in trade to and from the U.S. ICS must assume it is not the intention of Congress to now destroy the U.S. based container leasing business by making it uncompetitive with its foreign based competitors.

2. Except for certain movable (containers, airplanes and ships) and other statutorily enunciated personalty, Congress has already denied the ITC and accelerated depreciation for personalty leased outside the U.S. S. 1564 would in large measure reverse that long standing legislative

policy covering these exceptions without appropriate consideration to its international and business implications.

3. ICS has built its business over the past twenty years. It is not a Johnny-come-lately that recently found a tax loophole that requires this present Congress to correct.

4. ICS is subject to U.S. taxation on its worldwide income. It has not engaged up to now in off-shoring any part of its container fleet in order to avoid U.S. taxation.

5. ICS leases all its equipment on a dollar denominated basis, and is therefore a positive contributor to the U.S. balance of payments.

6. Much of ICS' business is done with foreign steamship companies that are covered under tax treaties which provide special treatment for those companies. Indeed the treatment of ICS worldwide revenues is also covered under one or more tax treaties and it is we understand, the policy of the Treasury Department to expressly include container rental revenue in ongoing treaty negotiations so as to limit taxation to the situs of the lessor or owner. To now materially alter the tax aspects of ICS' business may have serious implications to those treaties, the rental rates those steamship companies will have to pay, and the taxable revenues of ICS.

UNITED STATES CONFERENCE OF MAYORS
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William Donald Schaefer
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Daniel K. Whitehurst
Mayor of Fresno
Executive Director:
John J. Gunther

July 26, 1983

The Honorable Robert Dole
United States Senate
SH-141
Washington, D.C. 20510

Dear Senator Dole:

The U.S. Conference of Mayors appreciates the opportunity to comment briefly, for the record, on S.1564, legislation introduced by you, Senator Durenberger, and Senator Metzenbaum to restrict the leasing activities of governmental units and non-profit organizations. We have several concerns about this legislation as it affects the activities of state and local governments.

While we understand Congressional concern over paper transactions and the recent leasing activities of the U.S. Navy, we believe the bill goes much further than it should, and has many unintended effects. For example, the bill threatens important infrastructure projects in cities, including resource recovery, wastewater treatment, and sewer facilities; the privatization initiatives of the Administration; economic development projects; historic preservation and rehabilitation efforts in cities; and many of the equipment and vehicle leases of state and local governments. The Conference of Mayors urges this Committee to look much more closely at these effects on important state and local activities.

We appreciate some of the improvements which you have made in the original bill introduced by Congressman Pickle, H.R.3110. However, we would recommend these additional alterations: (1) an exemption for projects involving substantial rehabilitation or new construction, (2) the continuation of current law with respect to the rehabilitation tax credit. This rehab tax credit provision in your bill is extremely harmful to development efforts in cities across the country, and has held up Urban Development Action Grants in some places, 3) deletion of the service contract provision of the bill so as to ensure that the leasing of vehicles and equipment and service contracts for garbage collection, resource recovery, and other city services can continue as under current law, and (4) a change in the effective date of the legislation -- to date of enactment rather than May 24.

While the Conference of Mayors realizes these changes are rather broad in scope, we do not believe they hurt the basic intent of the legislation to restrict paper transactions -- the sale and leaseback of city assets to the private sector for refinancing only and where no rehabilitation or new construction is involved.

One final comment on the effective date of the legislation. The Conference of Mayors considers it poor public policy to introduce legislation with an immediately effective date. This subverts the Congressional process since it effectively stops all activity, however meritorious, pending final Congressional disposition of the legislation. Before any Congressional committee has approved the legislation -- much less the Congress as a whole -- the legislation has the full force and effect of the law. We would strongly urge that the effective date be the date of enactment.

We appreciate your consideration of these proposed changes, and would be happy to work with your staff to draft legislative language which would effectively take care of cities' problems. We thank you, Senator Dole and the members of the Finance Committee, for your support of other urban programs over the past year, including the extension for mortgage revenue bonds and the reauthorization of revenue sharing.

Sincerely,

John J. Gunther

John J. Gunther
Executive Director

Ramsey/Washington County
WASTE
TO
ENERGY
PROJECT

Washington County Courthouse
14900 61st Street North
Stillwater, Minnesota 55082
612/439-3220

July 15, 1983

Mr. Roderick A. DeArnend, Chief Counsel
Commission on Finance
Dirksen Senate Office Building Room SD-219
Washington, D.C. 20510

Subject: S-1564 Governmental Leasing, Financing Reform Act of 1983

Dear Mr. DeArnend:

I am writing on behalf of the Washington and Ramsey County Board of Commissioners to oppose the transition provision of S-1564, Governmental Leasing Act of 1983. We object to the application of the Act to projects that have required the expenditure of public resources during the planning process, but that have not yet entered the final phase of written binding contracts for acquisition and construction.

Washington and Ramsey Counties have jointly undertaken a Waste-to-Energy Project, that will burn 600 tons of municipal solid waste per day. (Please see Attachment A for a brief overview of the Project). As indicated by the overview, St. Paul, Ramsey County and Washington County have worked for three years on the Project, in response to the public need for an alternative form of disposing of solid waste. Washington County has issued $4 million in general obligation bonds on July 12, 1983 to provide interim funding for preliminary costs for the Project, while Ramsey County is assuming responsibility for two-thirds of the debt service payments.

Moreover, the Counties are in negotiations with 3M over the sale of steam produced at the waste-to-energy facility. 3M will buy one-half of one billion pounds of steam annually. Finally, a site has been selected, and the land acquisition process will begin this fall. In sum, a great deal of effort, time and money have already been expended in an attempt to dispose of solid waste by burning.

The Counties have not, however, made a final decision regarding the ownership and operation of the Facility. Private ownership is an option that the Counties are seriously considering, pursuant to the Minnesota Waste Management Act, Minnesota Statutue ¶473.803, Subdivision 1, which provides that local government should encourage private ownership and operation of solid waste facilities. While we understand the merits of S-1564, we feel that it is unfair that the provisions of S-1564 would preclude private ownership of the Facility as an option, at this late date in our planning process.

Respectfully submitted,

Douglas G. Wood

Douglas G. Wood
Washington County Deputy Administrator/Project Manager

cc: Robert J. Orth, Chairman, Project Board
Warren Schaber, Chairman, Ramsey County Board
Art Schaefer, Jr., Chairman, Washington County Board

Attachment

ATTACHMENT A

Ramsey/Washington County
WASTE
TO
ENERGY
PROJECT

PROJECT OVERVIEW

Ramsey County and Washington County generate approximately 1,400 tons of refuse per day, most of which is deposited in area sanitary landfills which are fast approaching their capacity. A recent study prepared for the Metropolitan Inter-County Association (MICA) projects that all area landfills will be full by 1987. To deal with this problem, the Legislature passed the Waste Management Act of 1980, which requires the Metropolitan Council and the seven metropolitan counties to either site new landfills or find alternatives to land disposal of solid waste.

Simultaneously, the counties are preparing land disposal abatement plans containing projects that could significantly reduce the need for new landfills. The proposed Ramsey/Washington County Waste-to-Energy Project is one such project.

In 1980 the City of St. Paul received a federal grant from the Environmental Protection Agency (EPA). The purpose of the grant was to determine whether or not a waste-to-energy project would serve the best interest of the residents in the area. In other words, would this kind of project meet state mandated requirements and also meet the citizens' needs for safe, effective waste disposal?

The City has completed two phases of the study:

Phase I was conducted to determine an appropriate market and identify from a list of 130, the City's ten best potential uses of steam.

Phase II studied in detail the degree of interest and energy needs with 3M's corporate headquarters emerging as the best market.

Phase III addressed public sponsorship, financing and the siting process. This phase was done through a Joint Powers Administrative Agreement between the City of St. Paul, Ramsey, and Washington Counties.

Phase IV - Procurement, environmental impact statement, request for proposals for facility vendors and investment banker, land acquisition, facility ownership options. This phase is currently being conducted through a Joint Powers Agreement between Ramsey County and Washington County.

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COMMITTEE ON FINANCE

UNITED STATES SENATE

HEARINGS ON S. 1564

THE GOVERNMENT LEASING REFORM ACT OF 1983

WRITTEN TESTIMONY OF

ROBERT L. HOGUET

VICE PRESIDENT

KIDDER, PEABODY & CO., INCORPORATED

August 2, 1983

INTRODUCTION

My name is Robert Hoguet, and I am a Vice President of the investment banking firm of Kidder, Peabody & Co. Incorporated. My main area of professional involvement is public finance and I am responsible for Kidder, Peabody's activities in the resource recovery area.

I am pleased to be able to say that Kidder, Peabody & Co. Incorporated is the leading investment bank with respect to managing financings for waste-to-energy facilities.

TESTIMONY

In General

The restrictions on tax incentives, set forth in S. 1564, should not apply to transactions such as solid waste disposal service agreements where a taxpayer is providing the community with an essential public service. Rather, S. 1564 should follow H.R. 3110 as passed by the House Committee on Ways and Means.

Our concern arises from the bill's ambiguous language concerning long term contracts between governmental units and taxpayers/lessors who are providing a service. Particularly, we are concerned that the delegation to the Secretary to promulgate regulations will force bond counsel to obtain a ruling from the Internal Revenue Service before a transaction can be consummated. This concern will be discussed below in detail.

In addition, given the delay in the promulgation of regulations, there is no assurance as to when a ruling could be obtained.

In such circumstances, neither the communities nor the owner/operators are engaging in the transaction merely to make use of otherwise unavailable tax benefits on a state or local government income tax exemption. If a governmental unit chooses to own a solid waste facility, no tax incentives are available. If, instead, a taxpayer owns and operates the same facility, the taxpayer is subject to Federal income tax laws, *i.e.*, its income is not sheltered because it has a contract with a tax-exempt entity. From the owner/operator's standpoint, the only reason for entering into the transaction is profit. In resource recovery transactions completed in the past two years which used the available tax benefits, the owner/taxpayer's risk has been substantial, *i.e.*, the owner's damages for failure to perform are severe, and the Company is subject to changing energy prices. Finally the facility and personnel are subject to his control. These factors are mentioned in S. 1564.

The principal problem with replacing raw landfilling through the construction of solid waste disposal facilities is the immediate high capital cost for a plant. The combination of ACRS, ITC and tax-exempt financing has helped to overcome this problem by lowering the amount of debt initially necessary for construction costs. Entrepreneurial vendors commit their own capital to the construction fund knowing the availability of tax incentives. Presently, raw landfilling solid waste is a cheaper method of waste disposal than is resource recovery. We estimate that this will continue to be true for as much as a decade. Landfilling raw waste is certainly wasteful in terms of land use and energy policy; moreover, it has been determined by the EPA to be unsound environmentally. Unfortunately, the initially higher costs of resource recovery have been deterring many communities from pursuing waste to energy plants as a long term solution to their garbage disposal problems. Given these facts, a reduction of the currently available tax incentives would be counterproductive to the nation's environmental policy (increasing the cost of service will delay switching from raw landfill) energy policy (raw landfill foregoes the potential heat value obtained from incinerated trash) and land use policy.

The development of waste to energy plants is an extremely long and costly process. It is not unheard of for a facility to take up to ten years from initial conception to implementation. Private and public sector participants together spend millions of dollars during that time. Given these circumstances, it is important from a national policy standpoint that as stable an atmosphere as possible prevail, so that planning may proceed in an orderly progression. Only last year, the 96th Congress considered the same issues which are addressed by S. 1564, and determined that the tax benefits available under current law should continue. We see nothing which has occurred in the last twelve months to cause a reversal of the policy decisions in this regard which were reached in 1982.

Service Contract or Lease

It is our position, in general, that Service Agreements between operators and communities are not leases. They are long term solely to provide assurance to bondholders that the technological difficulties associated with these commplex facilities will be dealt with satisfactorily. Additionally, long-term contracts insure communities that they indeed have a solution to their garbage disposal problem.

In the transactions financed to date, the operator bears immense risk of loss from nonperformance and/or may concurrently use the facility to provide services to taxable entities. On the other hand, the communities do not control the facility and have given up their economic interest in the property such as residual value. Given the fact that the communities bear some risks for uncontrollable circumstances and their service fee usually has some relationship to energy values, if S. 1564 were passed without excluding such facilities as solid waste, sewer and water, no transaction could be closed without a ruling from the Internal Revenue Service.

Factually, a ruling cannot be requested until a contract has been negotiated. The delay associated with a ruling request, because of escalation due to inflation, could cost a community millions of dollars. We simply believe it is not prudent tax policy to needlessly, increase, the cost of community services. Finally, it should be noted that frequently the Internal Revenue Service declines to rule until regulations are promulgated; it is not uncommon for the Treasury to take years before regulations are issued as a Treasury decision.

Additional reasons for not restricting current tax incentives for public use facilities, such as solid waste are:

1. A governmental unit's purchase of service such as garbage treatment from a taxpayer is a legitimate contract in which both parties take risks and gain rewards; accordingly, tax laws should not discriminate against either the community purchasing a service or the owner/operator which provides it. The Committee should except from its contract rule transactions involving necessary community services such

as solid waste projects, water transmission facilities and sewer plants.

2. Where a service agreement does not shift the real benefits and burdens of ownership to the community, the operator should not lose tax benefits which are available under current law and thereby increase the cost of providing a service. Also, the Committee should have no concern about a so-called "double-dip." The only unique tax incentive for these types of facilities is the availability of tax-exempt financing. ITC and ACRS operate as a capital formation tool as they do for any other taxpayer making a capital expenditure.
3. The services are not related to a select group such as municipal employees in an office building or sports fans at a stadium but rather apply to all of the citizenry within the facility service area. In fact, solid waste disposal services from refuse to energy facilities are generally available to customers other than a prime community, *i.e.* private haulers, commercial entities and neighboring jurisdictions.

4. It would be ironic for the Federal government, first, to terminate its grant programs dealing with the elimination of garbage on the premise that private industry should handle the issue and subsequently take away legitimate incentives from the solid waste industry as it seeks to fill the void.
5. Requiring a ruling from the IRS in this area would increase the cost of service to a community without a corresponding benefit to its citizens or the U.S. Treasury.
6. Current law, in addition to supplementing sound environmental and energy policy, aids this industry in obtaining capital. Adverse changes of existing law could well delay projects and could possibly force municipalities and industries to continue to landfill raw waste with the consequent death knell of the industry.

damson
OIL CORPORATION

August 11, 1983

Roderick DeArment, Esq.
Chief Counsel
Senate Finance Committee
215 Senate Dirksen Office Building
Washington, D. C. 20510

Dear Mr. DeArment:

On August 1, 1983, the Taxation Subcommittee of the Senate Finance Committee held hearings on, inter alia, S. 1549. The legislation is designed to alter the unrelated business taxable income rules as these relate to working interest positions in oil and gas ventures.

Damson Oil Corporation has made abundantly clear over a period of several months its many concerns about and opposition to the legislation. The company fully concurs with the myriad criticisms leveled at S. 1549 by both the Department of Treasury and the Southland Royalty Company in their respective statements to the Committee.

We respectfully request that this statement of our views be made a part of the formal hearing record.

Very truly yours,

DAMSON OIL CORPORATION

By: ______________________
Monte E. Wetzler
Executive Vice President

Damson Oil Tower • 396 West Greens Road • P.O. Box 4391 • Houston, Texas 77211 • (713) 583-3333

STATEMENT OF THE PUBLIC SECURITIES ASSOCIATION

INTRODUCTION

The Public Securities Association is pleased to submit this statement concerning the Governmental Lease Financing Reform Act of 1983 (S. 1564). This broadly phrased bill proposes several notable tax law restrictions in the area of municipal leasing. For example, it would require that property "used by" state and local governments be depreciated using the straight-line method over extended recovery periods and would tighten further the use of investment tax credits for such property. S. 1564 would only effect lease transactions in which the lessee participated in the bond financing. However, the bill is drafted in a complicated manner and an adequate understanding of all implications of the bill is difficult. The bill does provide special treatment for certain high technology property and is more liberal than a similar House bill regarding the rehabilitation tax credit. Upon preliminary analysis of this proposal, it appears that it is likely to have wide-ranging and significant implications to the continued use of many valuable forms of state and local government capital raising transactions. Perhaps most unsettling for state and local governments and the investment community is the fact that this legislation has been introduced with a May 23, 1983, effective date.

PSA is the national trade association which represents brokers, dealers, and dealer banks active in the municipal securities market, the U.S. Government and federal agencies securities market, and the mortgage-backed securities market. We currently have nearly 300 member firms whose offices are located in all 50 states. Last year, our members participated in over 95 percent of the dollar volume of new issues of state and local government securities. These same firms also account for the vast majority of secondary market trading activity in municipal securities. Our membership participates in the full range of dealer activities, and includes small firms dealing in special assessment issues and local financings, multi-million dollar investment banking powers, full service national wire houses, major money market center, and regional dealer banks. Member firms serving state and local governments perform a wide variety of financial services, not limited to underwriting of public debt issues. Accordingly, the industry is concerned about any legislative limitation which would appear to impair the ability of states and localities to finance themselves.

PSA OPPOSES RETROACTIVE EFFECTIVE DATE

PSA is still studying and considering its policy position on the tax law changes associated with S. 1564 and H.R. 3110, its companion bill in the House, and, more generally, on the appropriate role of leasing transactions (e.g., this term is used herein to encompass the more traditional lease/purchase transaction, as well as, lease/tax benefit transactions and other arrangements in which a private entity agrees to provide a public service) in the municipal securities market. We do, however, have a longstanding position in opposition to retroactive Federal legislation. This legislation which, was introduced on June 29, 1983, may not be voted upon until the latter part of the year yet, as noted earlier, would apply to property placed in service after May 23, 1983.

In recent years, the introduction of Federal legislation affecting the municipal securities market with a retroactive effective date has become more common. This practice has a severely unsettling effect on the market because it creates uncertainty for both state and local governments and investors. The result is to increase the costs of all transactions which may be affected by such legislation and to divert attention away from the public policy issues involved in the legislation. Even more fundamentally, PSA believes that retroactive dating of legislation represents an extraordinary application of the legislative process which should only be undertaken in connection with areas clearly requiring immediate legislative action on the part of Congress. In matters involving public finance, retroactive dating of legislative proposals may effectively accomplish, without Congressional consideration or majority vote, the objectives which were sought by the legislation's sponsor or sponsors merely through introduction. The introduction of such proposed legislation usually destroys the ability of state and local governments to carry on the financing programs which such legislation would affect, and, therefore has serious disruptive effects on the municipal market.

LEGISLATION RAISES MANY SIGNIFICANT PUBLIC POLICY ISSUES

PSA recognizes that the question of the appropriate role of state and local governments in municipal leasing transactions is replete with significant public policy issues. Therefore, we urge the Congress to take a deliberate approach as it reviews and deliberates upon this complex tax law question, The investment community recognizes and appreciates the pressures faced by the Congress to reduce projected Federal budget deficits. However, Congress must not consider this legislation solely in terms of the debate concerning steps to reduce the size of these deficits.

Due to the prevailing concerns regarding deficits, we fear that Congress will consider this legislation with the view that any growth in the use of tax benefit transactions is inherently objectionable. In many respects, growth in the number of municipal leasing transactions may represent merely the natural consequence of other congressional and state legislative actions which have reduced the levels of revenues previously available. Therefore, we believe that the impact of this legislation must be reviewed on its own merits, and carefully analyzed from the point of view of the broad public policy objectives which it seeks to implement. Among the most significant of these public policy issues is the degree to which Congress wants to promote the "privatization" of many of the services heretofore provided by government. We wish to note that this has been one of the frequently stated objectives of this Administration. PSA believes that, in many respects, the use of private sector tax incentives to complement and enhance public sector functions is entirely consistent with the "privatization" effort.

While PSA shares concern with many in Congress about the size of the deficit, we believe that the most prudent approach to our economic situation is adherence to a comprehensive economic development plan whose primary focus should be reducing the rate of growth of federal spending, stable monetary growth, stimulating savings and investment and elimination of unnecessary and burdensome federal regulation.

In reviewing the available public information on this subject, it has become clear that there is very little data concerning the scope and volume of municipal leasing transactions used by state and local governments. It seems particularly inappropriate for the Congress to be considering legislation which, in our judgment, is potentially significant, without any firm statistics regarding the dimensions of its use. However, we are conducting a survey of our members to try to gain a better understanding of both the scope and nature of municipal leasing activity. We will be glad to share the results of this survey with Congress in the coming weeks.

LEGISLATION MAY RESTRICT USE OF EXEMPT-FACILITY IRBs

Despite our limited opportunity to assess the effects of this legislation, it at least appears that its impact would be quite broad. We wish to note that this legislation, among other things, may represent another in a series of attempts to eliminate certain valuable forms of state and local government financings which provide capital to projects which are operated by private entities. More particularly, we are concerned about the potential impact of the proposal on projects financed by exempt facility industrial revenue bonds. PSA would be concerned to the extent such restrictions would effectively eliminate the ability of state and local governments to raise capital to finance traditional public purpose municipal revenue bond facilities such as airports, port facilities, convention centers and public power facilities.

Today, municipal financing for such projects is essential for the construction or redevelopment of infrastructure and facilities necessary for the social and economic well-being of all citizens. The fact that private parties may operate or otherwise benefit from these facilities simply reflects the historic practice of state and local governments in providing public works necessary to support and maintain residential communities and commercial and industrial development.

Last year, after much public debate, the Congress imposed new limitations on small-issue IRBs. The consensus necessary for adoption for this legislation was slow in developing. Implicit in last year's debates concerning small-issue IRBs, and, indeed implicit in Congress' decision to limit restrictions merely to the small-issue area, was a recognition of the very valuable role of other forms of tax-exempt bonds in achieving public purpose and benefit. PSA believes that these bonds have been used consistent with the mandate provided by Congress in the original industrial development bond law as passed in 1968.

MUNICIPAL LEASING TRANSACTIONS ARE NOT FREE OF MARKET IMPOSED LIMITATIONS

The published remarks which accompanied the introduction of S. 1564 raise another point concerning the "circumvention" of the traditional state and local government debt issuance approval process which we believe requires clarification. It has been suggested that municipal leases or similar arrangements may lead to the undertaking of projects which could not be bond financed because of voter disapproval or limits on indebtedness. We wish to point out, however, that state and local governments participating in these transactions are subject to the same market restraints as arise in connection with typical bond financing.

Appropriations of state and local governments for payment in connection with municipally leased property are made annually and generally represent an operating budget expenditure. Lease/purchases tend to represent more essential type equipment and property, to ensure annual re-appropriation.

We also wish to point out that this form of transaction inherently involves the same type of credit considerations as exist in other forms of municipal finance. Although this form of transaction may not be subject to debt limit restrictions, the creditworthiness of the state or local government issuer remains a critically important consideration. For example, as a participant in this type of transaction, one would certainly want to know the operations budget (deficit) projections of the municipal user. Therefore, it is not likely that we will witness profligate uses of this form of transaction.

Moreover, in the municipal lease/tax benefit transaction, the obligation of the state or local governments is typically viewed as debt, under state law. The negotiated contract terms in such transactions generally impose a promise by the issuer, in advance, to make payment beyond the current appropriations. Such obligation is therefore considered debt, and is subject to the same debt approval process as that which exists in connection with issuing municipal bonds. In addition, the credit analysis undertaken by the investor is the same as that arising in connection with the purchase of municipal bonds. Finally, we note that, in most instances, the level of due diligence review and the number of tax opinions issued are at least as numerous as those typically issued in connection with municipal bonds.

MANY RESTRICTIONS ALREADY EXIST IN THIS AREA

In response to the adoption in 1981 of the safe harbor leasing provisions of section 168 of the Internal Revenue Code, many state and local governmental entities have become increasingly aware of the value tax benefits can provide in the generation of capital. While the use of municipal leasing and other tax benefit transactions are not enirely new phenomena, the publicity following the enactment of the Economic Recovery Tax Act has encouraged state and local governments to reexamine the role that such transactions may play in providing vital services to their citizenry. Congress must recognize, however, in reviewing this matter, that a large number of restrictions have already been included in the Tax Code which significantly limit state and local government use of tax benefit transactions.

It seems appropriate at this time to review some of the most significant of these limitations. As mentioned earlier, S. 1564 would require in certain cases that depreciation deductions for property used by tax-exempt entities, e.g., state and local governments, be computed by using the straight-line method over extended recovery periods. However, the ability to recover the cost of property on an accelerated basis under ACRS is limited in cases in which property is the subject of a safe harbor lease transaction entered into after July 1, 1982, or is financed with the proceeds of certain tax-exempt industrial revenue bonds and placed in service after December 31, 1982. The cost of safe harbor leased property (other than mass commuting vehicles and certain transition property) must be recovered over a slightly extended period of time. The cost of property financed with certain IRBs must be recovered on a straight-line basis over the ACRS life.

There are also significant limitations on the ability of state and local government use of investment tax credits and energy tax credits. Section 38 of the Code provides for the allowance of a credit (ITC) directly against tax liability for an investment by a taxpayer in certain recovery property and certain other depreciable property. Notable among the exclusions from the definition of section 38 is ". . . property used by the United States, any State or political subdivision thereof . . . or any agency or instrumentality of any of the foregoing." The Treasury regulations already interpret the language "property used by" in this exclusion to mean "property leased to any such governmental unit." It should be noted that this exclusion for property used by a governmental entity is equally applicable to the energy tax credit (ETC). Moreover, in the event that 100 percent of the cost of "energy property" is provided with the proceeds of IRB's, existing tax law restrictions and Treasury regulations would preclude the use of an ETC.

The Code also provides for a special rehabilitation investment tax credit in connection with the rehabilitation of certain qualified real estate. Unlike the ITC and ETC, this credit is available with respect to buildings leased to governmental unit or tax-exempt entity. However, it should be noted that this credit may be taken only in lieu of both the ITC and the ETC. Moreover, in determining the amount of "qualified rehabilitation expenditures" the cost of acquiring the building and costs of enlarging it are specifically excluded. Finally, it should be noted that the Code and Treasury regulations already require that no expenditures on rehabilitation will be qualified unless the taxpayer elects to use the straight-line method of recovery rather than the normal ACRS method.

In examining the propriety of this legislation it is important for the Congress to recognize that, in order for the lessor in a straight-lease transaction or the purchaser-lessor in a sale-leaseback transaction to be able to claim the tax benefits associated with ownership of the property, the tax code and the Treasury regulations already require that the transaction is considered a financing arrangement and the lessor will be viewed merely as a lender and thus not entitled to claim any tax benefits.

CONCLUSION

In closing, we again caution the Congress against taking any hasty action in this area. PSA believes that an accurate and complete examination of the issues involved cannot take place given the information concerning these transactions which is presently available. Even more importantly, we believe the public policy issues involved are both significant and complex and consequently require thorough debate and consideration.

Finally, we would like to reiterate our strong objection to the retroactive effective date contained in this legislation. The planning and approval process for many of the projects affected by this legislation may take up to one year or more to complete. Therefore, merely from a standpoint of equity, it is particularly damaging and unfair to impose the limitations being proposed by S. 1564 on these projects with are already well into the planning and development pipelines.

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